No. G02-45

BEFORE THE INSURANCE COMMISSIONER
OF THE STATE OF WASHINGTON

In the Matter of the Application regarding
the Conversion and Acquisition of Control of
Premera Blue Cross and its Affiliates

PREMERA'S HEARING BRIEF

April 23, 2004

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GENERAL INTRODUCTION

Premera requests that the Commissioner approve its conversion from a non-profit to a for-profit corporation (the "Conversion"). In addition to the Conversion being appropriate under the Holding Company Acts, the Conversion would be of benefit to Premera's present and future subscribers and to the insurance-buying public in general. It would also result in the creation of a multi-million dollar charitable foundation that would help address the health care needs of the residents of Washington.

By permitting Premera to obtain capital through the equity markets, the Conversion will do three things that are at the heart of the Commissioner's statutory duties under the Holding Company Acts and, more generally, under the insurance code. The Conversion will strengthen Premera's reserves. It will give Premera access to capital to support membership growth and thereby serve the insurance-buying public. And it will provide capital for investments in infrastructure and products which benefit its current and future subscribers. At the same time, the Commissioner will be facilitating the creation of the largest endowment ever dedicated to meeting health care needs in the State of Washington.

Authorizing the Conversion at this time will redound to the benefit of Premera's subscribers, the insurance-buying public, and the residents of Washington for years to come.

SUMMARY OF THE FACTS

The purpose of the Summary of the Facts is to provide the Commissioner with an overview of the facts that pertain to the Conversion. The support for the statements made herein is to be found in the pre-filed testimony of Premera's witnesses[1], in the reports of Premera's experts, and in Premera's other hearing exhibits.

[1] For ease of reference to the names of Premera's witnesses, a copy of Mr. Mitchell's March 31, 2004 letter to Carol Sureau, which accompanied the pre-filed direct testimony of the 19 Premera witnesses, is attached hereto (following the appendices) as **Exhibit A**.

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I. The reasons for, and the benefits of, the Conversion

A. Why Premera's Board of Directors decided to convert Premera from a non-profit to a for-profit company

Sally Jewell, a member of the Premera Board of Directors (the "Board") who has served on the Board for nine years, articulates in her Pre-Filed Direct Testimony the reasons why Premera's Board unanimously recommended that Premera convert.

She explains that, after a series of meetings at which the various alternatives were thoroughly considered, "the Board concluded that a conversion is prudent to strengthen the company's capital position."[2]

The Board's reasoning was straightforward. Premera's current capital position is among the lowest of any Blue plan. Premera is well positioned to grow its membership, which will bring its products and services to more members. But that will require more capital. In evaluating the alternatives for raising capital, the Board concluded that the most viable option by far was to access the equity markets through a conversion to for-profit status.

Ms. Jewell also explains that the additional capital will give Premera the financial resources to support membership growth while continuing to invest in information systems, new products, and programs that improve the quality of service to members. The conversion will also provide hundreds of millions of dollars dedicated to the healthcare needs of our state.

Gubby Barlow, the CEO of Premera, testifies in his Pre-Filed Direct Testimony that, with the Conversion, Premera "will be able to expand and develop new programs for current and prospective members."

The letter identifies each witness by name and position and gives a brief synopsis of his/her areas of testimony.

[2] Unless otherwise noted, all quotations in this Brief are taken from the Pre-Filed Direct or Responsive Testimony filed herein.

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Moreover, like its for-profit competitors, Premera will no longer be capital constrained. As a non-profit, Premera's sources of capital are effectively limited to its net income. However, Premera's operating margin is slim: last year, Premera's operating margin was only about 1.7% of its premium dollars.

"[The Conversion] will enable us to compete on a level playing field," Mr. Barlow testifies, "in offering products and services, and growing our membership. Creating a more viable company is directly in the interest of our members, and the insurance-buying public."

He also explains that, "[t]o stand behind our member's health care coverage, Premera must be financially sound." His testimony shows how access to equity capital will help Premera maintain financial stability. Such access will also enhance Premera's ability to strengthen reserves to meet its current and future obligations to policyholders. By strengthening its reserves, Premera will be better able to deal with rapidly increasing health care costs, to adequately cover its membership growth, and to protect against economic uncertainties. Thus, the Conversion will enhance Premera's ability to better serve its members and attract new members by remaining a strong local, independent plan.

The following pages provide more details to explain and substantiate why Premera's Board approved the Conversion and what the benefits are that will flow from the Conversion.

B. Premera's capital constraints

1. Premera's current RBC level is among the lowest of any Blue plan.

Capital reserves are measured using an index called the Risk Based Capital ("RBC") index. Premera's 2003 RBC level of 433% is among the lowest of any Blue plan nationwide. Premera believes it is prudent and responsible to have an RBC index of 500% to 600%.

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Kent Marquardt, the Chief Financial Officer of Premera, discusses the constraint that Premera faces in obtaining capital to position the company for growth in membership and to provide funds for investment in infrastructure and products. "For the last several years," he testifies, "the company has been capital constrained."

2. The NovaRest Report's analysis of Premera's capital situation

Donna Novak, an actuary and consultant with extensive NAIC experience, confirms Mr. Marquardt's testimony. Ms. Novak wrote the NovaRest Report. She testifies that Premera is considerably constrained in its access to the capital it will need to compete and grow in the future. This is because for year-end 2002, Premera's RBC level was only 406%, compared to the over 600% average of many other Blue Cross Blue Shield Plans and to the 500% RBC target of similar companies.

3. The best way for Premera to obtain additional capital is to raise it through the equity markets.

Ms. Novak's report and her Pre-Filed Direct Testimony demonstrate that the best way for Premera to obtain additional capital is to raise it through the equity markets. This is a superior method when compared to any of the alternatives, such as sale of assets, mergers, attempting to increase profits, or seeking to augment capital through debt.

Ms. Novak also testified that, whether they are for-profit or not-for-profit, all insurers still have similar profit needs in order to continue to meet increasing RBC requirements.

4. The Milliman Report shows that Premera's premium rate projections cannot meaningfully increase Premera's RBC.

Jerry Lusk, a principal with Milliman USA, Inc., a nationally recognized actuarial firm, testifies as to Milliman's finding that "rating margins in the current Premera premium rate projections are generally not sufficient to meaningfully increase Premera's surplus in relation to its RBC benchmarks."

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Milliman's finding thus further substantiates the testimony of Ms. Novak and of Premera's Board and management as to why Premera should access the equity markets in order to increase its RBC to an appropriate level.

C. The benefits of having access to capital markets

There are a number of benefits that will accrue from Premera's having access to capital markets.

1. Improvement in Premera's capital position

Access to equity capital enhances Premera's ability to strengthen reserves to meet its current and future obligations to policyholders. As indicated above, Premera's goal is to have an RBC index of 500% to 600% in order to handle rapidly increasing health care costs, cover potential membership growth, and protect against economic uncertainties.

2. Improved ability to increase membership and to support a growing customer base

Having access to capital markets will improve Premera's ability to increase its membership and to support a growing customer base.

Premera's investments in improved products and technology have been successful in attracting new members. Since year-end 1999, membership has increased by 38 percent. More than 550,000 Premera members are now using Dimensions[3] products. With upcoming product enhancements, Premera anticipates increased demand, resulting in continuing membership growth.

Membership growth is good for all members that Premera serves. Access to capital supports bringing new members onto Premera products and thereby benefits the insurance-buying public. Increased membership benefits existing and new members alike by spreading the cost of Premera's technology and infrastructure investments over a broader base, allowing Premera to deliver more efficient service.

[3] A detailed discussion of the Dimensions business platform is infra, at Section I.C.3.b.

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It is important to note that, as Premera grows in response to customer needs, its capital reserve requirements grow as well. With profit margins in the 1-2 percent range, it would take years before profits from those new members fully fund necessary reserves to support the larger customer base. However, Premera's RBC level is immediately impacted on the day it enrolls each new customer.

Access to equity markets will help Premera respond to future demand for its products by adding the flexibility to raise capital as needed to support membership growth.

3. Improvements in Premera's ability to deliver improved new products and services to its subscribers

Another benefit is that access to equity capital will permit Premera to make continued investments in products, services, and infrastructure that will better serve its customers and meet their expectations.

a. The health insurance business is highly capital intensive

Mr. Barlow testifies that the health insurance business is "a highly capital-intensive business." Capital is required to make continued investments in products, services and infrastructures to better serve subscribers and to meet their expectations.

b. The Dimensions business platform: an example of the use of capital

The Dimensions business platform was launched in January 2003. The Dimensions systems and administrative processes are designed to provide service at industry-leading levels. Premera developed Dimensions to respond to consumer and provider frustration with industry products that are inflexible, hard to understand, and complicated to administer.

The Dimensions platform has enabled Premera to develop products which provide customers choice and flexibility. It came about as the result of a major initiative that

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Premera undertook to redesign its entire service model, product portfolio, care facilitation approach and systems infrastructure.

Mr. Barlow explains that the essence of Dimensions is to offer choice in the coverages and services that Premera provides to its members. "From the members' perspective, benefits and networks can be matched to best meet their need. From the providers' perspective there is a single set of administrative rules and a single payment method, independent of the member's contract. Dimensions eliminates the complexity and confusion associated with different rules and payments for old HMO and PPO products."

Premera has invested significantly in Dimensions -- thus far, approximately $125 million -- in order to provide customers with a new generation of products, technology and services. And it will take additional ongoing investments to meet the evolving needs and expectations of Premera's customers.

But in a competitive business, more must always be done, just to keep up. And that takes more capital. Thus, Dimensions is an example of what Premera must do to remain responsive to its customers, not an end point. And it is an illustration of the capital costs of meeting customer needs.

c. Increased ability to meet the growing demands of technology

Yet another benefit of access to capital markets is that Premera will have an increased ability to meet the growing demands and costs of technology.

Investing in technology is not only an opportunity, it is also a necessity. As Alan Smit, Premera's Chief Information Officer, explains in his Pre-file Direct Testimony, there are a variety of marketplace factors requiring Premera to invest in technology at an accelerated rate. Those factors include: the competitive forces and expectations within the

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marketplace; industry trends to information technology ("IT") integration and connectivity; and responses to legislative and regulatory requirements.

All healthcare insurers continue to invest more heavily in IT to provide more choice and service, enabling them to compete more effectively for potential customers. The market compels Premera to offer the same or better technology resources as its competitors. As IT functionality becomes "industry standard," insurers develop entirely new functionality to continue to meet the next round of consumer expectations.

Premera and other health insurance companies face additional technology challenges. System integration -- securely connecting insurers with hospitals, clinics, pharmacists, and others -- is a significant challenge for a marketplace that has been technologically fragmented. Such integration is also viewed as a primary means to achieve administrative efficiencies, to improve quality and to contain industry costs.

Mr. Smit's testimony demonstrates the magnitude of the cost of technology. He cites a report from Gartner Dataquest which forecasts that IT spending in the U.S. healthcare market[4] will increase at a compound annual growth rate (CAGR) of 7 percent from $34.1 billion in 2001 to $47.9 billion in 2006.

Premera's firsthand experience mirrors that of the healthcare IT industry. Premera has substantially increased its IT spending over the last four years and it believes this increased level of spending will need to be maintained during the foreseeable future.

D. Conversion will serve Premera's subscribers, the public interest and the insurance-buying public.

Conversion will serve Premera's subscribers, the public interest and the insurance-buying public in a number of ways.

[4] Compared with other United States industries, healthcare is the second-fastest-growing market for IT, surpassed only by the government sector.

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1. Premera will be able to continue to remain a strong local, independent plan that is available to the insurance-buying public.

For the reasons stated above, the Conversion will enhance Premera's ability to deliver on its mission and vision for the benefit of its subscribers. And it will be able to do so while remaining a strong local, independent plan that will be available to the insurance-buying public in Washington.

2. Conversion will result in the creation of two foundations funded to serve unmet health care needs in Washington and Alaska.

The Conversion will result in the creation of two foundations -- one in Washington and one in Alaska -- that will be funded with hundreds of millions of dollars that would be used to serve unmet health care needs of the residents of those states. These foundations and their potential contribution to the public health are discussed in more detail in Section III below.

3. Premera's contributions to the economic health of Washington will be strengthened.

Premera is an important part of Washington's economy. It is a large employer and a major contributor to Washington's tax base. Strengthening it helps ensure that it will continue to be a vibrant contributor to Washington's economy.

E. Conversion will help Premera continue to achieve its corporate mission and visions.

Premera's corporate mission and vision are its guiding principles for serving the company's current and prospective members. Its mission is "to provide peace of mind to our members about their health care coverage." Its vision is to be "the health plan of choice and the standard of excellence in our region." Premera's business strategy is designed to meet its corporate mission and vision.

Access to capital markets will enhance Premera's ability to deliver on its mission and vision to its customers.

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1. Premera's corporate mission is dependent upon the company's financial soundness.

Premera's corporate mission -- "to provide peace of mind to our members about their health care coverage" -- recognizes that this is a consumer-driven business. The mission statement was established in 1998 by Premera's Board and its management team as they considered what Premera's value proposition should be for its members -- that is, why people come to Premera as customers. Premera concluded that what people want is the knowledge and the comfort that they have access to quality health care and that their health plan will stand behind their healthcare coverage.

In order to provide access to quality health care, Premera must offer a choice of coverage that meets the needs of its customers, coordinate effectively with the providers who care for them, and provide great service. To stand behind its members' health care coverage, Premera must be financially sound.

2. How the Conversion helps Premera achieve its corporate mission and vision.

Access to capital markets facilitate Premera's ability to obtain the financial resources required to make ongoing investments and to support its capital base.

Premera is in a highly capital-intensive business and access to capital is crucial. By way of example, Premera has made significant investments in Dimensions, but these are not one time investments, they are ongoing. Such investments are large relative to Premera's capital reserves. Premera seeks equity capital to continue to invest in new products, services, and infrastructure that will better serve its customers and meet their expectations. Additional capital will also support continued membership growth which helps spread costs across a larger membership base.

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II. How the Board deliberated and made its decision on the Conversion

In her Pre-Filed Direct Testimony, Ms. Sally Jewell explains the approach that the Board took in its deliberation on whether Premera should convert to a for-profit and whether now was the right time to undertake the conversion.

A. Events leading up to the Conversion decision

The Board has periodically assessed the issues surrounding the company's capital levels. In 1997, for example, the Board retained Goldman Sachs, which reviewed Premera's business structure, as well as its financial and capital position. After a series of discussions, and consistent with the advice of Goldman Sachs, the decision was made to merge Blue Cross of Washington and Alaska ("BCWA") and Medical Services Corporation of Eastern Washington ("MSC"), which had operated as affiliates in Washington since 1994. The merger, which was completed in 1998, proved beneficial by providing financial and operational integration of the two companies.

Premera's primary focus in the mid-to-late 1990's was to turn the company around financially. Premera had suffered significant losses in the 1990's which were largely the result of regulatory mandates related to the health insurance market for individuals.[5]

In 1999, the company returned to operating profitability. In 2000, the company launched its initiative to redesign the company's products, operations and systems, resulting in the Dimensions business platform which has been described above. The capital to support this project was raised through a series of sale and lease-back arrangements.

As Premera continued to grow, and with the potential for future growth based on the company's improved information systems and new products, the Board became

[5] Premera was not alone in having difficulties. During this same time period, several national health insurers left the State of Washington and the remaining carriers, like Premera, experienced significant losses in the individual market.

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acutely aware that, for every new customer who obtains coverage from the company, Premera must increase its capital reserves. The more the company grows, the greater its need for capital to support that growth. Unfortunately, Premera's capital level was then, and remains, among the lowest in the Blues system.

In 2001, the Board again considered the alternatives for increasing capital. In late 2001, the Board authorized management to conduct the necessary due diligence and to develop a plan for the Board's consideration regarding a potential conversion to for-profit status.

After numerous Board meetings on the subject over the course of an eight-month period, and with the assistance of independent financial and legal advisors, the Board reached a decision in May 2002 that Premera should convert, and authorized management to initiate discussions with state officials.

B. The approach that the Board used to reach its decision to convert

The Board's deliberations leading to its decision to convert began in August 2001 and culminated in May 2002. Those deliberations were diligent, methodical and thorough.

During the August 2001 board meeting, Goldman Sachs gave the Board its assessment of Premera's financial situation, an update on market dynamics, and a review of options for raising capital. At the Board's September 2001 meeting, Goldman Sachs presented an in-depth evaluation of capital funding options, including a conversion to for-profit status. The Board determined that the concept of conversion had merit. It authorized Premera's management to assist the Board in its due diligence in reviewing, assessing and deciding whether to pursue a conversion.

Over the next eight months, the Board held a series of regular and special board sessions, with the participation of its outside advisors, dedicated to an in-depth study of conversion, how it might be accomplished, Premera's attractiveness as a public company,

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and the specific proposal that was approved at the May 2002 meeting. Based upon all of the information presented and the Board's deliberations during the course of the previous meetings, the Board unanimously endorsed the decision to move forward with conversion.

C. Premera fulfilled its fiduciary duties in investigating and assessing the alternatives for capital formation.

John M. Steel, a partner in the Seattle office of Gray Cary Ware & Freidenrich LLP, reviewed the actions that the Board of Directors of PREMERA and the Board of Directors of Premera Blue Cross took in deciding to undertake a conversion. He concludes that those boards fulfilled their respective fiduciary duties under Washington law in investigating and assessing alternatives for capital formation. Their deliberative process met the requisite standard of care, and the decision to pursue the Conversion rather than other business combination alternatives met the requirements applicable to the fiduciary duties of a board of directors. As Ms. Jewell observes, the Premera Board's process in regard to the Conversions decision "has been one of the most diligent, methodical and thorough processes I've witnessed as a board member in any organization."

III. The proposed Washington Foundation for unmet health care needs

Premera has proposed to dedicate 100% of New PREMERA's initial stock on conversion to charitable foundations in Washington and Alaska. This stock would be sold in the public markets to create endowments to fund health-related initiatives in those states. The foundation that would be created for Washington is referred to hereinafter as the "Washington Foundation."

A. The value of the proposed foundations in Washington and Alaska

The Blackstone Group ("Blackstone"), the OIC Staff's investment banking consultant, provided an illustrative exhibit showing the value of Premera as between $500 and $700 million.

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Two witnesses -- Barbara Dingfield and E. Lewis Reid -- have submitted pre-filed testimony discussing the benefits to Washington's residents that could be achieved by the Washington Foundation.

Mr. Reid, the former CEO of The California Endowment**,** testifies that if the amount realized by the two foundations is in the range reported by Blackstone, the amount available to health philanthropy in Washington and Alaska would be equivalent, on a per capita basis, to the largest foundation ever created in a Blue Cross Blue Shield conversion.

B. How the Washington Foundation would compare to other charitable resources now available in Washington

As Ms. Dingfield explains, there are relatively limited resources from other charitable organizations and foundations in Washington for unmet health care needs. Also, those that do support health care projects are not exclusively dedicated to such health care purposes.

For example, the Seattle Foundation, the largest community foundation in the region, has an endowment of approximately $300 million. However, it has a very broad focus for its charitable giving; less than 25% of its annual grant making goes to health care related activities, mostly in the Puget Sound region.

As Ms. Dingfield concludes: "While I do not mean to in any way question the priorities of these foundations or to diminish the contributions that they make to our communities, the reality is that a well-funded charitable foundation dedicated to dealing with the unmet health care needs of Washington would be of enormous benefit to our citizens."

C. The needs that the Washington Foundation would address

1. Specific needs identified by community leaders and health care professionals in Washington

Ms. Dingfield testifies about the results of several discussion sessions with 20 Washington non-profit organizations, foundations and educational institutions that she

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facilitated at Premera's request in October 2003. The categories of unmet health care needs that these community leaders and health care professionals identified can be summarized into four categories:

(1) a shortage of nurses statewide and a shortage of doctors in rural areas;

(2) the lack of access to public health education and basic health care;

(3) the lack of sufficient prevention and wellness education and services; and

(4) the fact that certain health care specialties (mental health, dental and eye care, substance abuse treatment, and even primary care for the under-served) are not included in the health "safety net."

2. The broad range of needs that the Washington Foundation would be authorized to address

The Washington Foundation would have very broad authority to fund projects. Article III of the Articles of Incorporation of the Washington Foundation states that its specific purposes are to "promote the health of the residents of the State of Washington" by such measures as:

(1) improving health education and awareness;

(2) improving the quality of health care and access to health care and related services;

(3) addressing the unmet health care needs of low-income uninsured and underinsured populations;

(4) supporting the education of health care providers to increase the number of active physicians, including specialists, and nurses in medically underserved areas;

(5) supporting programs aiming to (a) make health care delivery more comprehensive and flexible, and (b)

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develop and promote the most efficient uses of health care facilities, resources and services;

(6) supporting community based and culturally competent programs that may address one or more of the foregoing purposes;

(7) conducting health policy research and analysis for the development of health policy that will promote systemic change in the programs and activities related to the foregoing purposes; and

(8) providing grants and establishing programs to carry out such purposes.

D. Why the creation of the Washington Foundation serves the public interest

Mr. Reid's testimony, based on his experience with The California Endowment, California's counterpart to the proposed Washington Foundation, is compelling on the issue of how the Washington Foundation would serve the public interest.

His assessment is: "The Amended Form A filing presents the Commissioner with the opportunity to capture a massive benefit for residents of the State of Washington in perpetuity. In my judgment, it would be tragic to forgo such an opportunity."

Other Blue Cross and Blue Shield organizations around the United States have preceded Premera in establishing foundations at the time of conversions. One of the consequences of these conversions has been the creation of a new and vigorous group of health philanthropies in America. These philanthropies can address health needs of citizens that have been ignored, or are not susceptible of being solved by government and the existing health delivery system.

Ms. Dingfield's testimony also shows how important the Washington Foundation will be to addressing the unmet health care needs of those who most need help in our state.

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IV. The Conversion will facilitate on-going investments in Premera's healthcare quality programs.

The pre-filed direct testimony of John Gollhofer, M.D., who is the Chair of the Board's Quality Committee, and of Roki Chauhan, M.D., Vice President of Medical Services and Medical Director for Quality at Premera, discuss Premera's core facilitative programs and the need to continue investing in those programs.

A. Premera's care facilitation and disease management initiatives

Currently, Premera has a number of care facilitation and disease management initiatives. Dr. Chauhan's testimony provides details about the innovative care facilitation programs that Premera has developed to help members obtain, and providers deliver, quality cost-effective care. These programs emphasize preventive care, member education, and provider best practices. They include Care and Case Management, Disease Management, Health Awareness Education and Pharmacy Services. These programs have received high marks from health care providers and Premera's members, as well as national recognition.

B. The active role of the Board's Quality Committee

The active role of the Quality Committee demonstrates that Premera is thoroughly committed to the health and satisfaction of the Company's members.

Premera's quality initiatives have a profound positive impact on the lives of its members. Its programs are among the most progressive and effective available in Washington.

C. The Conversion will allow Premera to continue and expand its quality initiatives.

Dr. Chauhan testifies that the development and expansion of these initiatives "will require ongoing investment by the company." The Conversion will help provide the funding needed for their continued expansion, to the benefit of Premera's current and future members.

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As Dr. Gollhofer concludes: "Premera's quality initiatives have a profound positive impact on the lives of its members."

V. The Conversion will not cause premiums to increase or lead to a reduction in consumer access to health insurance products or to health care providers.

The Intervenors assert, without support, that the Conversions will somehow cause premiums to go up and otherwise be harmful to the subscribers and the insurance-buying public. These assertions are speculative and unsupported.

Indeed, contrary to the Intervenors' assertions, there is ample evidence -- both in the published literature and in the testimony of expert witnesses in this case -- that the Conversion will not cause premiums to increase or lead to a reduction in consumer access to health insurance products or to health care providers.

A. The New England Journal of Medicine Study shows no difference in the quality of care provided by for-profit vs. non-profit companies.

A recent study published in the New England Journal of Medicine refutes the assertions by the Intervenors and a number of their witnesses that for-profit health care companies stop serving the interests of their customers. A copy of the New England Journal study is attached as Exhibit A to Ms. Jewell's Pre-Filed Responsive Testimony.

The New England Journal study found that for-profit companies take care of their customers as well as, if not better than, non-profits. The study examined the widely held belief that for-profit plans are more susceptible to respond to financial incentives by restricting access to care. The study concluded that:

> Contrary to our expectations about the likely effects of financial incentives, the rates of use of high-cost operative procedures were not lower among beneficiaries enrolled in for-profit health plans than among those enrolled in not-for-profit health plans.[6]

[6] Schneider, Zaslavski, and Epstein, *The New England Journal of Medicine*, "Use of High-Cost Operative Procedures By Medicare Beneficiaries Enrolled in For-Profit and Not-for-Profit Health Plans", January 8, 2004, p. 143 (emphasis added). Attached as Exhibit A to Ms. Jewell's Pre-Filed Responsive Testimony.

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B. The Feldman, Wholey, and Town Study found no increase in premiums after conversions in other jurisdictions.

In February 2003, Professors Feldman, Wholey and Town, who are affiliated with the Division of Health Services Research and Policy in the School of Public Health at the University of Minnesota, issued their study, entitled "The Effect of HMO Conversions to For-Profit Status." This study, commissioned by the Maryland insurance regulators, evaluated the effect of conversion on premiums, provider reimbursements, and accessibility. A copy of the study is attached as Exhibit A to Dr. McCarthy's Pre-Filed Responsive Testimony.

The Feldman, Wholey and Town Study examined empirically what effect, if any, prior HMO conversions have had on premiums and reimbursements. They found that prior conversions have resulted in premiums *decreasing* slightly and provider reimbursements remaining basically the same. Their conclusion was: "Although health insurance markets are hugely complex, we were able to discover several patterns of behavior that appeared regularly among the converting HMOs. The results do not provide unequivocal evidence that HMO conversions are either beneficial or detrimental to the public interest."

C. The NERA Report found that the Conversion would not cause premiums to increase or reduce consumer access or choice.

The head of the NERA team is Thomas McCarthy, Ph.D, a healthcare economist. He testifies that NERA's study demonstrates that the markets that Premera competes in for health insurance and for provider services are competitive. He also shows that the Conversion is not going to change this. He further concludes that the Conversion is not going to substantially lessen competition or tend to create a monopoly in the health coverage business.

Dr. McCarthy also concludes that the Conversion "is not going to reduce consumer access to health insurance products or health care providers." He notes that, whether for-

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profit or non-profit, Premera will continue to offer only those products and services that make commercial sense. Further, there are sound economic reasons why Premera will continue to contract with health care providers in rural counties: "[Premera] considers its large provider network to be one of its competitive strengths and it uses that advantage to compete for members, including the large multi-site employers that have employees located throughout the state."

D. The Milliman Report concluded that there would be no increase in premiums after the Conversion.

The Milliman Report evaluates the likely premium rate impact, if any, of the conversion of Premera. To do so, Milliman modeled the margins and resulting premium rates under two scenarios and projected both scenarios through the year 2008. Milliman concluded that "Premera's conversion is not likely to result in any material impact on its premium rates." [Emphasis added.]

The Pre-Filed Direct Testimony of Mr. Lusk, an experienced actuary, details the work that was done to reach that conclusion. Comparing the results under the two scenarios ("Without Conversion" and "With Conversion"), Milliman found that the modeled premium rates over the next five years do not vary significantly between the two scenarios. Indeed, the premium rates in the "With Conversion" scenario would be slightly lower -- by 0.5% -- than the premium rates in the "Without Conversion" scenario.

VI. The Conversion will not have a negative impact on the level of provider reimbursement or on subscriber access to providers.

There is ample evidence -- again from both studies and pre-filed testimony -- that the Conversion will not have a negative impact on the level of provider reimbursement.

This evidence contradicts the unsubstantiated "concerns" of those opposed to the Conversion that the change to a for-profit status will result in Premera reducing provider reimbursements or changing the products that it offers. In fact, competitive market forces

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and regulatory rules -- which apply with equal force to for-profits and non-profits alike -- determine provider reimbursements and product offerings.

A. The Hall and Conover Study shows no change in pricing, underwriting or product offerings after conversions in other jurisdictions.

Mark A. Hall (Wake Forest University) and Christopher J. Conover (Duke University) published a study, which appeared in 2003 in the Milbank Quarterly, a journal of public health and health care policy. The study is entitled "The Impact of Blue Cross Conversions on Accessibility, Affordability, and the Public Interest." A copy of the study, based upon work done for the North Carolina insurance regulators, is attached as Exhibit B to Dr. McCarthy's Pre-Filed Responsive Testimony.

Hall and Conover conducted interviews with the market participants involved in health care in four states where Blue Cross plans had converted to for-profit status: California, Georgia, Missouri and Virginia. They found that most market participants felt that there was little change in the plans' behavior in pricing, underwriting, and product offerings after the conversions took place. The authors also found that most market participants felt the primary drivers in the plans' behavior are the competitive market forces and regulatory rules, rather than the organizational form or corporate culture. Based on their interviews, Hall and Conover concluded that "conversions don't have a strong or consistent negative effect on affordability or accessibility."

B. The Feldman, Wholey, and Town Study found no change in provider reimbursements after conversions in other jurisdictions.

The Feldman, Wholey and Town Study, discussed above in regard to its conclusion that premiums did not increase after conversions, also considered the impact of conversions on provider reimbursement. Again, it found that there was no change in provider reimbursements: the reimbursements remained basically the same.

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C. The NERA Report demonstrates that the Conversion will not have any impact on provider reimbursement.

The NERA Report and the testimony of Dr. McCarthy further substantiate the conclusion that the Premera conversion will not decrease provider reimbursement rates.

The NERA Report goes into considerable detail in analyzing the data and literature that support its conclusions. Without purporting to summarize all of that evidence, there are a few key points that can be highlighted.

Premera has a number of competitors, both in Eastern and Western Washington. Many of those competitors have very competitive provider networks on both sides of the mountains. Those competitors have been able to gain membership, on occasion at the expense of Premera. Moreover, Premera needs to maintain broad and stable provider networks in order to remain competitive.

The testimony of Brian Ancell, Premera's Executive Vice President of Health Care Services and Strategic Development, and of Heyward Donigan, Executive Vice President and Chief Marketing Officer, explain the importance of provider networks to Premera's success and show how the health care providers in Washington have significant levels of bargaining power.

Mr. Ancell explains in his pre-filed testimony how broad and stable provider networks are important to Premera's success. Premera recognizes -- as it must if it wants to succeed in providing services to its subscribers -- that market appropriate provider compensation and good provider relations are essential to maintaining those networks.

Premera works very hard to balance the need to pay providers a market-competitive rate with the need to cope with the demand by the insurance-buying public for lower premium rates. As Mr. Ancell testifies: "Competition forces Premera to remain in line with other insurers in the state as to provider reimbursement and member premiums."

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It is Mr. Ancell's experience that the providers throughout Washington possess significant levels of bargaining power with Premera and that there are no limits on the ability of a health plan wishing to enter, or expand within, the Washington market in establishing provider networks. Ms. Donigan, as the Chief Marketing Officer, also testifies to the highly competitive environment in which Premera does business in the state of Washington.

Dr. McCarthy's study of the market in the state of Washington leads him to testify that: "[W]e find no evidence that the conversion is going to cause an increase in premiums to consumers or a decrease in reimbursement rates to health care providers compared to competitive levels."

Dr. Gollhofer concludes: "[F]rom my experience as a practicing physician for 26 years, and as a Board member, I believe Premera is committed to working collaboratively with the physician and provider community. I further believe that the proposed conversion will have no adverse impact on physician reimbursement or rural healthcare."

VII. Premera's Executive Compensation is reasonable and appropriate now and will continue to be so after the conversion.

There have been some concerns expressed as to what the impact of the Conversion will be upon executive compensation. Those concerns are unfounded.

A. The Premera Board follows best practices in setting executive compensation.

Premera's Board follows best practices and has only independent directors on its Compensation Committee. No employee of Premera is a member of the Compensation Committee.

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The testimony of Patrick Fahey, who is the Chair of Premera's Compensation Committee,[7] provides an overview of the roles of the Committee and the Board in setting Premera's executive compensation. He also explains the work done by the Committee to ensure that its compensation practices are consistent with best practice in the health plan industry.

As Mr. Fahey explains, the Board's executive compensation philosophy is that it should be appropriate and reasonable for a company in the health plan industry. Premera's Board recognizes that it needs to attract and retain high quality executive management, motivate its corporate officers to achieve Premera's business objective, and align the interest of key leadership with the long-term interests of the company. Thus, the Board aims to make Premera's executive compensation program competitive with the compensation of the executives at its peer companies. The Compensation Committee generally targets the market median base compensation of the peer group, but it remains open to paying above that range, depending on the experience of the executive and the strategic needs of the company.

The Compensation Committee's decisions about executive compensation are based upon market data provided by Premera's external compensation expert, Mercer Human Resource Consulting Inc., and the advice and counsel of that firm.

B. Premera's *current* executive compensation programs are reasonable and appropriate.

Richard Furniss, a principal with Towers Perrin, a well-respected national executive compensation consulting company, testifies that Premera's current executive compensation programs are reasonable and appropriate.

He confirms that the Compensation Committee of the Board has done a good job of making independent judgments about compensation needs. It properly makes use of a

[7] Mr. Fahey is also the Chairman of Regional Banking for Wells Fargo Bank.

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nationally recognized compensation consultant to assist it in making an independent determination of the proper compensation levels for Premera's executives.

C. Premera's *post-conversion* executive compensation will be reasonable and appropriate.

Mr. Furniss testifies that, based upon his evaluation of Premera's proposed executive compensation program, there is every reason to conclude that its post-conversion compensation for its executives will be reasonable and appropriate. Premera will continue to have an independent Compensation Committee that utilizes a compensation consultant to help provide the Committee with the information it needs to make an independent evaluation of compensation.

The Compensation Assurances that are now a part of the Amended Form A should provide additional comfort that Premera's post-conversion compensation will be appropriate.

The Compensation Assurances can be found at Exhibit E-8 to the Amended Form A. They require Premera to establish a peer group from a list of companies developed with the input and approval of the OIC Staff's compensation consultants. To the extent that there are any changes in the make-up of the peer group (say, due to a merger of one of the peers into another company), the new substitute peer company must be chosen from six health insurance companies that were suggested for use as peers by the OIC Staff's compensation consultants.

Additionally, the Compensation Assurances provide that the Washington Foundation shall have the right to nominate a member of the Board of Directors and that that member shall serve on the Compensation Committee for a term of three years.

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D. Premera's equity incentive program is competitive but very conservative.

The equity compensation program was approved by Premera's Board after extensive discussions between Premera and the OIC Staff's consultants. Premera made major changes in the equity compensation plan to address the concerns of the OIC Staff's consultants. These changes resolved all of the concerns expressed by the Blackstone Group (the OIC Staff's investment banking consultants) save one, which has now been resolved as well.

Mr. Furniss's evaluation of Premera's plan for proposed post-conversion stock grants to executives is that the equity incentive plan will align the interests of management with those of shareholders. He finds that Premera's equity incentive plan is "competitive but very conservative."

E. There are significant restrictions on the use of stock options.

There are significant restrictions on the use of stock options under Premera's Amended Form A that will ensure that any stock option grants do not exceed reasonable and competitive levels. In fact, there is a one-year blackout period before any stock options or other stock awards can be granted to Premera's executives. If the executives eventually obtain any reward through those options, it will be because they have managed the company in a manner that adds value for the shareholders. That is, in order for the executives to receive any compensation as a result of exercising their stock options, there first has to be an increase in the stock price. Such an increase means that all of the shareholders, including the foundations, are also benefiting.

The OIC Staff's compensation consultant, Mr. Nemerov, suggested some additional restrictions on Premera's executive compensation programs. Mr. Furniss's Pre-Filed Responsive Testimony reviews Mr. Nemerov's proposed restrictions and concludes

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that they are ill-advised. Mr. Furniss also testifies that any additional restrictions on the stock program, or on the compensation programs in general, are unnecessary and would be harmful to Premera's ability to compete and potentially harmful to its policyholders.

VIII. Premera's strategy to gain access to the public equity markets is reasonable and the for-profit Premera, structured as is now proposed, will be an attractive investment.

The final factual area to be considered is an evaluation of whether an initial public offering ("IPO") is likely to be successful.

Premera's investment banking experts and the OIC Staff's investing banking experts[8] agree that Premera has every prospect of executing a successful IPO.

The OIC Staff's consultants and Premera's experts conclude that (a) Premera should take advantage of its current financial position to undertake the IPO and (b) Premera's rationale and performance metrics should satisfy investor expectations and should be viewed as an attractive investment.

A. Why Premera should take advantage now of its current financial position to access the public equity markets

The BAS Report explains that companies raise capital for two broad reasons: (i) to fulfill specific near-term needs and (ii) to provide strategic flexibility. Companies often raise capital before an actual specific need arises in order to achieve strategic flexibility.

Here, both BAS and Blackstone agree that a public offering is the only mechanism for raising substantial capital which will enable Premera to increase its RBC level.

Additionally, gaining access to the public equity markets should enable Premera to facilitate raising future capital that may be necessary as the Company grows.

[8] Premera's proposal to convert and to have an IPO was reviewed and analyzed by the Healthcare Group of Global Corporate and Investment Banking at Banc of America Securities ("BAS") in New York; Brian Kinkead is the Managing Director of the Healthcare Group. The OIC Staff retained Blackstone; Martin Alderson-Smith and Jonathan Koplovitz are with Blackstone.

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B. Premera's rationale and performance metrics should satisfy investor expectations and it should be viewed as an attractive investment

If Premera undertakes an IPO, investors will analyze the strengths and weaknesses of its operations based upon what they view to be the important characteristics and core competencies of successful health insurance companies. In addition, investors will require that Premera have certain performance metrics, such as size, profitability, growth and margin, that are comparable to similar health insurance companies that have undergone this type of transaction.

BAS and Blackstone agree that Premera's IPO rationale is comparable to the rationales of other successful health insurance IPOs, and Premera's metrics fall within or near the range of nine recent health insurance companies that have undergone an IPO.

C. Premera's Audit and Compliance Committee provides financial safeguards.

Premera already has in place many of the financial safeguards that it will need as a public company.

Richard P. Fox is the Chair of the Audit and Compliance Committee at Premera. He is a licensed CPA and Partner at RavenFire LLC. He has held a number of positions in the private sector, including the Managing Partner in the Seattle office of a public accounting firm. In short, he has extensive financial and auditing experience.

Mr. Fox's testimony describes the role of the Premera Board's Audit and Compliance Committee in overseeing Premera's internal controls, financial reporting, and readiness to become a public company. He explains how the Board has a strong commitment to the integrity of the company, as evidenced by its oversight of internal controls, financial reporting, and corporate compliance with laws and ethical standards.

The Audit and Compliance Committee operates independently from Premera management. It follows best practices for a non-profit corporation subject to regulation under the insurance code and other applicable laws. Premera has a long history of

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adopting best practices related to audit and compliance functions such as its adoption of the recommendations of the Blue Ribbon Commission on the Effectiveness of Audit Committees, and early adherence to the applicable provisions of the Sarbanes-Oxley Act.

D. The two-year limit for the Amended Form A's Economic Assurances should not be extended.

In Premera's Amended Form A, Premera agreed to a number of two-year post-conversion economic assurances specific to the Washington market (see Exhibit E-8 to the Amended Form A). These assurances should not affect Premera's ability to achieve its financial projections; therefore, Premera would be still viewed by the market as an attractive investment.

The OIC Staff's consultants and some Intervenors suggest that the term should be increased beyond two years. However, to extend these assurances could place Premera at a disadvantage relative to its competitors and therefore would have a negative impact on Premera's attractiveness to investors.

E. The OIC Staff's Consultants' governance terms are not prudent.

The OIC Staff's consultants have recommended governance terms that are at odds with those set forth in the Amended Form A.

The inclusion of some of these terms and conditions in Premera's transaction documents would be inconsistent with the requirements to maintain Premera's BCBSA license.

The BCBSA license, which authorizes Premera to use the "Blue Cross" and "Blue Shield" trademarks, is an essential and valuable asset of the company. Because of the value of the mark, Premera cannot make changes to the transaction terms that would be inconsistent with maintaining its BCBSA license. The loss of Premera's BCBSA trademark rights would significantly impair the value of the Company.

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The specific measures proposed by the OIC consultants and what their effects would be on Premera are discussed in the legal argument below and their effects are discussed in BAS's Supplemental Report.

Even if the BCBSA were to consent to some or all of the changes requested by the OIC staff consultants, BAS does not believe that adopting them is likely to enhance the value of the Company in the eyes of investors. Accordingly, Premera should not be asked to undertake any of them because they would jeopardize its BCBSA marks and therefore would impact the Company's value to shareholders and the viability of the IPO, without adding any material benefit to the Foundations.

F. The overall structure of the Conversion regarding the foundations is reasonable and customary.

Mr. Steel concludes that "the overall structure of the arrangements between New PREMERA and the [foundations] -- including that reflected in the Registration Rights Agreement, the Voting Trust and Divestiture Agreements, and the Transfer, Grant and Loan Agreement -- is reasonable and customary, including those aspects of structure that also serve to comply with the Blue Cross Blue Shield Association … license."

LEGAL ARGUMENT

I. Under the Criteria Set Forth in the Holding Company Act, Premera's Amended Form A Must Be Approved.

The Insurance Commissioner's evaluation of the Conversion of Premera to for-profit status must focus upon the standards set forth in RCW 48.31C.030, the Holding Company Act for Health Care Service Contractors and Health Maintenance Organizations (the "HCA").[9] It is the HCA that establishes the requirements for Premera's Form A, outlines the procedures by which that Form A is to be examined and tested, and spells out

[9] The Commissioner's authority over most of the transactions in this conversion arises from the HCA. LifeWise Assurance Company and LifeWise Health Plan of Arizona, Inc., are covered by the Insurer Holding Company Act, ch. 48.31B RCW (the "IHCA").

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the criteria for approval or disapproval of the Form A. *See* RCW 48.31C.030(2), (4), and (5), respectively.[10]

The HCA gives the Commissioner broad power to seek information from Premera and to hire experts to help analyze the conversion. *See* RCW 48.31C.020 - .040, .070. By contrast, the HCA provides specific criteria pursuant to which the Commissioner may disapprove the conversion. The HCA provides that the Commissioner "shall approve an acquisition of control unless, after a public hearing," he makes an adverse finding on specified criteria. RCW 48.31C.030(5)(a). In this case, the HCA prohibits disapproval of the Conversion unless the Commissioner makes a finding that (1) New PREMERA will not be able to satisfy the requirements for registration as a health carrier, or (2) the Conversion will have an anticompetitive impact on the market for health coverage.

As a subset of the second test, the HCA lists four more criteria[11]: whether the financial condition of the acquiring party might jeopardize the financial stability of the health carrier; whether plans to liquidate, sell, or merge the health carrier are unfair and unreasonable to subscribers and not in the public interest; whether the competence, experience, and integrity of the persons who would control the health carrier are such that it would not be in the interest of subscribers and the public to permit the acquisition; and whether the acquisition is likely to be hazardous or prejudical to the insurance-buying public. *See* RCW 48.31C.030(5)(a)(ii)(C)(I) – (IV).

Neither the OIC Staff nor any other party has provided the Commissioner with the legal or factual foundation necessary to make the findings required for disapproval. The

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[10] A separate provision of the HCA, RCW 48.31C.050, establishes requirements for transactions within a health carrier holding company system (i.e., Form D transactions). In conjunction with the Conversion, Premera has proposed certain inter-company transaction that are governed by Form D. They are, for the most part, uncontroversial.

[11] Whether these factors can be applied independently of the HCA's antitrust test is discussed below and in Appendix A. This brief addresses all six factors and demonstrates that, if they apply, Premera's proposal readily passes muster under all of them.

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evidence shows that the conversion will provide a fresh influx of capital, which will both benefit Premera's subscribers and create a substantial charitable endowment to address unmet health care needs in Washington. The evidence also shows that the conversion will achieve these substantial benefits without altering the competitive landscape, adversely affecting Premera's subscribers and the public interest, or harming the insurance-buying public.

A. Those Who Oppose the Conversion Have the Burden of Proof to Justify Disapproval.

The HCA places the burden of proof squarely upon those who would seek to block Premera's conversion. Subsection 5(a) of RCW 48.31C.030 states:

> The commissioner shall approve an acquisition of control referred to in subsection (1) of this section unless, after a public hearing, he or she finds that:
>
> (i) After the change of control, the domestic health carrier referred to in subsection (1) of this section would not be able to satisfy the requirements for registration as a health carrier;
>
> (ii) The antitrust section of the office of the attorney general and any federal antitrust enforcement agency has chosen not to undertake a review of the proposed acquisition and the commissioner pursuant to his or her own review finds that there is substantial evidence that the effect of the acquisition may substantially lessen competition or tend to create a monopoly in the health coverage business.

(Emphasis added.)[12]

The framework laid down by subsection 5(a) is clear. The HCA presumes that an acquisition of control, such as Premera's conversion, is acceptable, for it mandates that the Commissioner "shall approve" the conversion in the absence of specific findings set forth

[12] Subsection 5(a)(ii), continuing, elaborates on the Commissioner's determination under this second prong and the role of the Attorney General. Here the Attorney General has elected to provide her input during the course of the proceeding rather than to undertake a separate review. No federal agency has sought to participate.

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in the HCA.[13] The HCA allows the Commissioner to disapprove the conversion only if New PREMERA cannot satisfy the registration requirements for a health carrier or if there is "substantial evidence" that the conversion is anticompetitive. Unless the Commissioner can make one of these findings, he must approve the conversion.

B. There Is No Basis to Make the Findings Required under RCW 48.31C.030(5)(a)(i) and (ii) to Disapprove the Conversion.

1. The OIC Staff and Its Consultants Admit that the Requirements for Registration as a Health Carrier Are Met.

Subsection 5(a)(i) of the HCA sets forth the first ground for disapproving a Form A: "After the change of control, the domestic health carrier [control of which is being acquired] would not be able to satisfy the requirements for registration as a health carrier." On this ground, there is no dispute: Premera satisfies all applicable registration requirements.

On March 20, 2003, the OIC Staff informed the Staff's legal consultant, Cantilo & Bennett LLP ("C&B"), that Premera's health care service contractor licenses may be transferred to proposed successor entities without going through a full licensing procedure. Ex. S-31, p. 28, n.63. In its original report, C&B concluded that "PREMERA seems to have satisfied this requirement [of being able to satisfy a domestic health carrier's registration requirements]." *Id.*, at 14. That conclusion stands. *See* Ex. S-33 (Exec. Summ.), p. 9.

2. The Conversion Will Not Have an Anticompetitive Effect.

Subsection 5(a)(ii) of RCW 48.31C.030 directs the Commissioner, absent intervention by state or federal antitrust authorities, to examine a Form A transaction for antitrust injury. The HCA establishes a stringent standard for the Commissioner to find competitive harm: Is there "substantial evidence that the effect of the [conversion] may

[13] *Accord* RCW 48.31C.030(4) ("The commissioner shall approve …").

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substantially lessen competition or tend to create a monopoly …"? (Emphasis added.) In this case, there is no such evidence, much less a substantial amount.

The OIC Staff's consultants agree with Premera's economic expert that the proposed conversion will not cause competitive harm. Dr. Leffler, the OIC Staff's consultant, writes:

> At a purely structural level, this proposed conversion does not appear to raise significant antitrust issues. The proposal would only convert Premera and its nonprofit affiliates to for-profit corporations. No competitor would be acquired in the proposed transaction, and no market share in any market would be increased. Thus the typical market effects of increased market power from an acquisition are not present.

Ex. S-17, pp. 4-5. "The conversion does not directly affect in any way the number of competitors offering health insurance in Washington, and it, therefore does not directly impact competition." *Id.* at 2. Dr. McCarthy, Premera's expert, concurs:

> The proposed conversion is not going to "substantially lessen competition or tend to create a monopoly in the health coverage business" in the state of Washington. The relevant markets that Premera competes in for health insurance and for provider services are competitive. The conversion is not going to change this.

McCarthy Direct, p. 1.[14]

Because this is a transaction among affiliates that will have no immediate impact upon Premera's market share, C&B concludes that the transaction is exempt from any antitrust inquiry under the IHCA. Ex. S-31, pp. 29-30 (*citing* RCW 48.31B.020(2)(b)(iv), (2)(v)(B)).[15]

[14] Citations to previously submitted pre-filed direct testimony and pre-filed responsive testimony in this matter are indicated by "[Last name] Direct, p. __," and "[Last name] Resp., p. __," respectively.

[15] Parallel exemptions exist in the HCA. *See* RCW 48.31C.020(5)(b)(iv) and (5)(b)(v)(B). C&B observes that the Commissioner and the AG may apply the IHCA exemptions to the HCA by analogy. While this is certainly true, the Commissioner and the AG can also apply the HCA exemptions directly via the cross-reference to RCW 48.31C.020 in RCW 48.31C.030(5)(a)(ii).

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With respect to the HCA, C&B discusses the possibility that the conversion and IPO might "induce and enable" Premera to engage in anticompetitive practices, resulting in future increases in its market share. *Id.*, p. 30. C&B concludes that "the causal link between the two events is too speculative to result in a finding that the Transaction fails the Antitrust Inquiry." *Id.*[16] The C&B conclusion that Premera's proposed conversion easily passes muster under the test set forth in RCW 48.31C.030(5)(a)(ii) is reiterated in its supplemental report: "it is improbable that the Amended Transaction will violate antitrust laws." Ex. S-33 (Exec. Summ.), p. 9.

C. The Factors Enumerated Under Subsection 5(a)(ii)(C) Do Not Come into Play Unless There Is an Anticompetitive Effect.

Under the literal terms of the HCA, the conclusions just discussed are sufficient to require approval of Premera's Form A. The HCA establishes only two criteria pursuant to which the Commissioner may disapprove a proposed acquisition: those set forth in subsection 5(a)(i) and 5(a)(ii). The additional factors listed in subsection 5(a)(ii)(C) come into play only if there is an antitrust injury. This point is addressed further in Appendix A hereto.

D. Premera's Form A Satisfies All of the Factors Listed Under Subsection 5(a)(ii)(C).

Even if the factors under subsection 5(a)(ii)(C) apply independently, the OIC Staff's consultants and the Intervenors have not established the necessary factual and legal foundation for a finding that any of these factors is present.[17]

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[16] C&B discussed this matter with AAG John Ellis in October 2003. They concluded that "the potential deployment of capital was too speculative to raise any antitrust concerns." They also described this as a "non-issue." Email from Andrew Taktajian to John Ellis, 10/25/03 (Ex. 20 to the Deposition of Patrick Cantilo, 3/22/04) ("Cantilo Dep., 3/22/04"). As Mr. Cantilo has testified: "[O]ne cannot conclude that the availability of capital which might be used improperly in and of itself should result in a criticism of a transaction intended to make that capital available." *Id.*, at 357.

[17] The failure to establish any of these factors also requires approval under the IHCA, RCW 48.31B.015(4)(a).

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1. This Transaction Will Strengthen, Not Impair, Premera's Financial Stability.

Subsection 5(a)(ii)(C)(I) of the HCA asks whether the financial condition of the acquiring entity will "jeopardize the financial stability of the health carrier, or prejudice the interest of its subscribers[.]" In this case, no one suggests that the Conversion threatens Premera's financial stability and, with it, Premera's ability to support subscribers. On the contrary: Premera is undertaking the Conversion in order to gain access to the equity markets, which will strengthen its financial condition.

The investment banking experts that have examined Premera's Form A, BAS and Blackstone, agree that Premera will be an attractive investment and that its capital position ("RBC") will be strengthened by the transaction.[18] Therefore, New PREMERA's financial condition post-conversion, far from jeopardizing the financial stability of the company or prejudicing the interest of its subscribers, will improve matters over where they now stand. C&B's supplemental report implicitly concedes the point. *See* Ex. S-33 (Report Text), p. 13.[19]

2. Premera's Conversion Will Further the Interests of Its Subscribers and Promote the Public Interest.

a. This Factor Poses a Single Question.

Subsection 5(a)(ii)(C)(II) of the HCA sets forth a lengthy test, only part of which is relevant here. It asks whether

> The plans or proposals that the acquiring party has to liquidate the health carrier, sell its assets, consolidate or merge it with any person, or to make any other material change in its business or corporate structure or management, are unfair and unreasonable to subscribers of the health carrier and not in the public interest. [Emphasis added.]

[18] Pre-Filed Direct Testimony of Brian Kinkead, pp. 4-7; Pre-Filed Responsive Testimony of Brian Kinkead, pp. 1-2, 5-6 & Ex. A.

[19] The concerns expressed in C&B's supplemental report regarding the IPO Procedures Opinion and the contemporaneous closing of the IPO (Ex. S-33, p. 14) have all now been resolved. *See* Marquardt Direct, pp. 21-22, 23; Cantilo Resp., ¶¶ 6, 9-10.

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In this case, there are no plans to sell or merge Premera. Premera's business will continue unchanged, and its management will remain intact, in successor for-profit corporations. Thus, only the underlined language above is potentially relevant, and the test may be rephrased as follows: Is Premera's proposal to change its corporate structure unfair and unreasonable to its subscribers and not in the public interest? The answer, most resoundingly, is "No."

Before explaining why this is so, we need to address an important aspect of this statutory test: the relationship between the interests of the subscribers and the public interest. What does the "public interest" mean here? It does not encompass everything that members of the public might be interested in. The public interest standard for the Commissioner is stated in RCW 48.01.030, entitled "Public Interest":

> The business of insurance is one affected by the public interest, requiring that all persons be actuated by good faith, abstain from deception, and practice honesty and equity in all insurance matters. Upon the insurer, the insured, their providers, and their representatives rests the duty of preserving inviolate the integrity of insurance.

See also Van Noy v. State Farm Mut. Auto. Ins. Co., 142 Wn.2d 784, 800, 16 P.3d 574, 582 (2001) ("RCW 48.01.030 defines the public interest in insurance.") (Talmadge, J., concurring).

This standard is concerned with honest and equitable dealings "in all insurance matters" and the "integrity of insurance." The standard focuses upon the interests of subscribers, as indeed do all of the factors enumerated in subsection 5(a)(ii)(C).[20] The close connection between the public interest and the interests of subscribers is strengthened by the language of subsection 5(a)(ii)(C)(II), for it uses the conjunctive "and" to join the interests of subscribers with the public interest. Those who urge disapproval of Premera's Form A must demonstrate that the conversion results in changes

[20] A principal objective of the Model HCA was to enable regulators to protect subscribers. *See* 1983-1 NAIC Proc. 94, 109.

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that are both "unfair and unreasonable to subscribers" and "not in the public interest." *See HJS Dev., Inc. v. Pierce* County, 148 Wn. 2d 451, 473 n.94, 61 P.3d 1141 (2003) ("[o]rdinarily, the word 'or' does not mean 'and' unless there is clear legislative intent to the contrary. Statutory phrases separated by the word 'and' generally should be construed in the conjunctive.") (citations omitted).[21]

The OIC Staff's consultants ignore both of these points, treating "public interest" as a separate test and one divorced from the public interest standard set forth in RCW 48.01.030. In particular, they seek to import the public interest standard from the Acquisition of Nonprofit Hospitals Act, ch. 70.45 RCW (the "Hospitals Statute"). The public interest under the Hospitals Statute provides for consideration of charitable concerns:

> The state also has a responsibility … to clarify the responsibilities of local public hospital district boards with respect to public hospital district assets by making certain that the charitable and public assets of those hospitals are managed prudently and safeguarded consistent with their mission under the laws governing nonprofit and municipal corporations.

RCW 70.45.010 (emphasis added).

In contrast, nothing in the definition of "public interest" under the Insurance Title of RCW suggests that the term "public interest" should be expanded to include an evaluation of the potential charitable obligations of an insurer. The Legislature's declaration of public interest and the language of subsection 5(a)(ii)(C) limits "public interest" to matters of insurance—that is, the insurer's dealings with current and future subscribers. There is no statutory construction rule that would allow the OIC Staff's

[21] The phrase "not in the public interest" may also be limited to adverse impact on subscribers under the doctrine of *ejusdem generis.* "That rule provides that general terms, when used in conjunction with specific terms, should be deemed to incorporate only those things similar in nature or 'comparable to' the specific terms." *Beckman v. State*, 102 Wn. App. 687, 691, 11 P.3d 313, 316 (2000).

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consultants to expand the concept of "public interest" under subsection 5(a)(ii)(C) by importing a contrary standard from a wholly different statute.[22]

In pointing out the statutory standards for application of the "public interest" test in RCW 48.31C.030(5)(a)(ii)(C)(II), Premera does not mean to suggest that its proposal could somehow be viewed as contrary to the public interest in any other sense of that term. On the contrary, as the testimony outlined at the beginning of this brief makes clear, the conversion is very much in the public interest, writ large. Among other things, it will provide hundreds of millions of dollars that can be used to address unmet health needs of Washington residents, while simultaneously strengthening Premera's ability to serve current and prospective subscribers.

b. Premera's Proposal Is Fair and Reasonable to Subscribers.

Access to capital after the conversion will allow Premera to better serve its current and potential customers. *See generally* Barlow Direct. Customers demand the same service from for-profit companies as they do from non-profit insurers, Donigan Direct, p. 9, and the conversion will not alter Premera's mission to serve its customers. Barlow Resp., p. 4 ("We will succeed after conversion only if we continue to stay tuned to the real interests of the insurance-buying public."); *see also* Barlow Direct, pp. 13-14.

Conversion is good for Premera's policyholders because it will allow the company to improve its capital position, resulting in a stronger, healthier company better able to meet its commitments to policyholders in the future. Barlow Direct, p. 11. Access to market capital will also support Premera's current and potential membership growth. *See* Fox Direct, p. 8 (access to equity capital will provide Premera greater financial flexibility and increased capacity for membership growth).

[22] The inapplicability of ch. 70.45 to this transaction is addressed further in Part III.A. below.

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In addition, investments in infrastructure and technology will offer greater possibilities post-conversion for increased service to Premera's customers. *See* Smit Direct, pp. 11-12 ("To continue to meet Premera's mission and vision it will need to continue its investment in technology to provide outstanding customer service."); Fox Direct, p. 8 ("We need to continually invest in infrastructure upgrades and new technology to enhance customer service and support new product development."). *See also* Chauhan Direct, pp. 10-11 (development and expansion of care facilitation programs will require ongoing investment by the company). Converting to a public company will not alter the fact that Premera's success depends on the satisfaction of its customers. *See generally* Barlow Direct.

c. The Concerns Expressed about the Conversion are Unfounded.

Intervenor and OIC Staff witnesses use the specter of shareholder pressure as a vehicle for expressing three general fears about adverse effects on Premera's subscribers: increased premiums, disruption to provider networks, and reduced services. None of these fears is well-founded. In fact, studies commissioned by insurance authorities in other conversion proceedings "demonstrate that the worries about higher premiums, lower reimbursements, and reduced accessibility have not resulted from the conversions that have actually been approved." McCarthy Resp., p. 9.

Premiums. Both before and after the conversion, Premera's interests will be firmly aligned with those of the policyholders it serves. Conversion will not cause premiums to rise for Premera's policyholders. *See* McCarthy Direct, p. 1-2 ("We find no evidence that the conversion is going to cause an increase in premiums to consumers…."); Lusk Direct, p. 1 ("Premera's conversion is not likely to result in any material impact on its premium rates."). Premium rates are subject to significant market pressures, and

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conversion will not change the importance of maintaining competitive premiums. *See* Donigan Direct, pp. 6-7.[23]

The PwC consultants constructed a model purporting to show the kinds of premium increases that Premera would need to enact in order to achieve target operating margins, but the PwC model is utterly devoid of predictive value. *See* McCarthy Resp., p. 17 ("model has no predictive usefulness."). Apart from the fact that the "target" margins reflect numbers assigned by PwC, not by Premera, the model does not purport to show, but merely assumes, that such premium increases are possible. It also assumes, mistakenly, that Premera would not lose significant numbers of customers if it were to act as PwC suggests. *See* McCarthy Resp., pp. 16-17. The OIC Staff's own actuary, Lichiou Lee, offers testimony directly at odds with the conclusions that PwC would draw from its model. PwC did not incorporate into its model any regulatory constraints, such as the requirement of revenue neutrality in the application of area factors described by Ms. Lee. *See id.,* pp. 14-15; Halvorson Resp., pp. 2-3. No valid conclusions may be drawn from the PwC model.

Nevertheless, to address the concerns raised by the OIC Staff's consultants, Premera has made a number of economic assurances respecting its rate-setting practices. These are set forth in Exhibit E-8 to the Amended Form A. Particularly in light of these assurances, there is no basis for any finding that the conversion will harm subscribers or the insurance-buying public.[24] Premera's assurances regarding premiums should offset any residual concerns. *See* Amended Form A, Exh. E-8(b); Halvorson Direct, pp. 1, 11.

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[23] The economics experts differ on the definition of the relevant market. That issue, which is rather technical, is addressed in Appendix B.

[24] The OIC Staff's consultants do not suggest otherwise. They urge the Commissioner, rather, to extend the length of the assurances from two years to three. There is no warrant for doing this. As Dr. McCarthy observes, "[t]he assurances are not needed. … [T]he markets in which Premera competes constrain its behavior." NERA Supplemental Report, p. 1. More importantly, the assurances "will likely create operational inflexibilities and competitive disadvantages for Premera that will only worsen over time. Therefore, they

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Providers. Conversion also will not damage the provider networks upon which Premera's policyholders depend. For Premera's policyholders, provider concerns are relevant only insofar as the conversion would have a deleterious impact on the health care provider network that they access. The evidence demonstrates that it will not.

Premera, as part of its commitment to providing peace of mind to its members about their healthcare coverage, has a interest in maintaining strong provider networks for its policyholders' use. Premera is very mindful that its members want broad access to providers, and the breadth of Premera's provider network is a significant competitive advantage. NERA Report, pp. 62-63; *see also* Gollhofer Direct, p. 8 ("In fact, the geographic breadth of Premera's network, including the rural areas, is viewed by the company as an important competitive advantage."); Ancell Direct, p. 3 ("Strong provider networks are very important to Premera's success for several reasons. We seek to provide choice for our members by offering several network options. These options include very broad networks with wide access."); McCarthy Direct, p. 2 ("Premera will continue to contract with health care providers in rural counties since it considers its large provider network to be one of its competitive strengths and it uses that advantage to compete for members, including the large multi-site employers that have employees located throughout the state.").

The OIC Staff's consultants agree; PwC does not identify an adverse effect on access to providers as a result of the conversion. *Cf.* Amended Form A, Exh. E-8(b) (Economic Impact Assurances), section 2. As Dr. McCarthy notes, "[t]he markets that Premera competes in for health insurance and for provider services are competitive. The conversion is not going to change this." McCarthy Direct, p. 1.

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should not be extended." McCarthy Resp. p. 13; *accord* Milliman Supp. Report, p. 2; BAS Supp. Report, p. 6. It makes little sense to hamper the workings of the market and to harm potential customers by limiting Premera's ability to compete and to innovate.

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Paying market-appropriate compensation to providers and maintaining good provider relations are important to Premera because they promote a healthy provider network. Ancell Direct, p. 1. Provider reimbursement is not, however, an interest that is protected under the HCA, for good reason. Considerable tension exists between the interests of subscribers and the insurance-buying public, on the one hand, and those of providers, on the other. Subscribers and the insurance-buying public are interested in holding down their premiums; providers are interested in avoiding lower or obtaining higher reimbursement levels, which will force premium increases. *See* Ancell Resp., p. 3 ("Every demand for higher payment levels by providers has a direct impact on the premiums our policyholders have to pay."); Gollhofer Direct, p. 6-7. Regardless, provider reimbursement rates likely will not decrease as a result of the conversion. *See* McCarthy Direct, p. 1-2 ("we find no evidence that the conversion is going to cause … a decrease in reimbursement rates to health care providers compared to competitive levels.").

Negotiations between insurers and providers occasionally become contentious, but each needs the other in order to serve current and prospective subscribers and patients. The corporate form of either the insurer or the provider is irrelevant to this negotiating dynamic. *See* Ancell Direct, p. 10 ("Premera's provider reimbursement rate setting and contracting processes will not change as a result of a conversion to for-profit status."). There is no reason to believe, therefore, that the conversion will have any impact upon provider networks.

Services. There is also no reason to believe that Premera will reduce services to its policyholders as a result of the conversion. The argument that for-profit health care companies stop serving the interests of their customers is unsupported. To the contrary, recent research has found that for-profits take care of their customers as well as, if not better than, non-profits. A study published in the New England Journal of Medicine

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examined the widely held belief that for-profit plans are more susceptible to respond to financial incentives by restricting access to care. The study concluded:

> Contrary to our expectations about the likely effects of financial incentives, the rates of use of high-cost operative procedures were not lower among beneficiaries enrolled in for-profit health plans than among those enrolled in not-for-profit health plans.

Jewell Resp., p. 1 (quoting Schneider, Zaslavski, and Epstein, "Use of High-Cost Operative Procedures By Medicare Beneficiaries Enrolled in For-Profit and Not-for-Profit Health Plans", New Eng. J. Med., January 8, 2004, p. 143).

Summary. The evidence does not support a finding that the conversion will cause changes that are "unfair and unreasonable to [Premera's] subscribers." The benefits that flow from conversion redound not only to Premera's policyholders but also to the insurance-buying public as a whole. A well-capitalized Premera that can better invest in infrastructure, innovation, and membership growth will contribute to a healthy diverse market. The strength of the market is a benefit to the insurance-buying public as a whole, not just that portion made up of Premera policyholders. *See* Barlow Direct, p. 14. The conversion is thus in the interests of the company, its policyholders, and the insurance-buying public.

d. The Conversion Will Not Affect the Directors' Duties to the Company or Premera's Policies Toward Subscribers and Providers.

An additional reason why the conversion will not result in changes that are "unfair and unreasonable to subscribers" and "not in the public interest" is that the duties of Premera's directors will remain unchanged. The assumption that a non-profit corporation necessarily acts differently from a for-profit corporation is false. The directors of non-profits and for-profits essentially share the same standard of care under Washington law.

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Both non-profit and for-profit directors must look to the "best interest of the corporation." *Compare* RCW 24.06.153(1) (non-profit statute for PREMERA) *and* RCW 24.03.127 (non-profit statute for Premera Blue Cross) *with* RCW 23B.08.300(1) (for-profit statute). For this reason, as well as the competitive environment in which both may find themselves, there is little difference between a for-profit corporation and a non-profit corporation that conducts a commercial business. The goal of both is to maximize profitability, business growth, and competitiveness. Thus, the conversion to for-profit status will not change Premera's current policies towards subscribers and providers. *See* Steel Direct, pp. 21-22; Steel Supp. Report, pp. 36-38.

3. There is No Evidence that the Competence, Experience, and Integrity of Premera's Board and Management are Contrary to the Interests of the Subscribers and the Public.

After the Proposed Conversion, Premera's Board and management will continue to be responsible for the direction and operations of the company, just as they are today. The credentials of this team are exceptional, and their competence, experience, and integrity cannot be justifiably be challenged. Indeed, as Blackstone has confirmed, these very qualities are among the key factors underlying the bright prospects of the proposed IPO. Particularly in the wake of the dot.com bubble and corporate scandals, the market is looking for companies that are strong on the fundamentals, such as sector leadership and high quality management. On these, "Premera is well placed." Alderson Smith Dep., 11/25/03, pp. 281-82. In addition, as Mr. Cantilo acknowledged, there is no question about the integrity of Premera's Board of Directors and management. Cantilo Dep., 3/10/04, p. 209.

The Board, not management, after an exceptionally thorough due diligence process, made the decision to pursue conversion unanimously. *See* Jewell Direct, pp. 3-8;

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Steel Direct, pp. 17-21.[25] Mindful that, in other proposed transactions, questions had been raised about the objectivity of analysis and due diligence conducted by persons who potentially stood to gain from the success of the proposal, Premera took pains to ensure that there was no basis for such questioning here. There are no bonuses or success-type payments tied to the approval or consummation of the Proposed Conversion. *See* Martin Alderson Smith Deposition, 11/24/03, pp. 58-59.

In deference to the Commissioner's request and at the urging of the OIC Staff's consultants, the Premera Board approved an equity compensation program for New PREMERA on October 17, 2003. Premera's equity compensation program, filed as Exhibit G-10 to the Amended Form A, is the product of extensive discussions between the State Consultants and Premera in 2003–04. It incorporates the State Consultants' input. The Amended Form A resolved all of the concerns previously expressed by Blackstone, save one technical concern.[26] Koplovitz Dep., 3/8/04, pp. 19-24; Ex. S-4, pp. 26-28. That question has now been resolved, too. *See* Cantilo Resp., ¶ 5.

> Richard Furniss concludes that the resulting program is "very conservative":
> I must say that the limitations that Premera now has on its post-conversion equity incentive plan are very restrictive and impose many more limitations than I normally see. The restrictions on the plan are more conservative than market practice and they should not be made even more restrictive. Thus, I would have to say that, with the restrictions, Premera's equity incentive plan is competitive but very conservative.

Furniss Direct, p. 13. In particular, Premera's stock program is very conservative relative to those found in other Blues conversions. For example, in WellChoice (the most recent conversion and the one cited by the OIC Staff's consultants as best practice), there was a

[25] Whether the Board's due diligence is properly subject to examination under the HCA and, if so, what standard should apply is discussed in Part III.B. below.

[26] The technical issue concerns whether the foundations are entitled to "free voting" or "mirror voting" on new stock programs to be effective after the three-year Stock Restrictions Period but put to a shareholder vote from the 25th through the 30th month of the Stock Restrictions Period. *See* Pre-Filed Direct Testimony of Kent Marquardt, p. 27.

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one-year waiting period but no further restrictions. In Premera's proposal, in addition to a one-year blackout period for stock options or other equity grants to management, there are numerous restrictions that continue for two more years. Among them are limits on the number of shares that can be used in equity programs and limits on the number of options or other grants to various officers.

Following an extended discussion on this and related issues, the C&B Supplemental Report concludes that "there is not enough evidence to conclude that the prospects of such additional compensation improperly influenced the conversion decision." Ex. S-33, p. 60.[27] Thus, even if such motivation would qualify as a reason to question the "competence, experience, and integrity" of the persons who would control New PREMERA, there is no evidence that would justify disapproval of the Proposed Conversion on this basis. This is consistent with Mr. Cantilo's testimony in which he affirmed the integrity of Premera's Board and management. Cantilo Dep. 3/10/04, p. 209.

4. There is No Basis to Find That the Conversion Is "Likely to be Hazardous or Prejudicial to the Insurance-Buying Public."

The last of the criteria listed under RCW 48.31C.030(5)(a)(ii)(C) focuses on the likelihood that the conversion will harm potential customers as well as current subscribers. In this case there is no evidence to suggest such harm. To the contrary, the effect of conversion will be to give Premera more capital to support a larger customer base and thereby serve more subscribers.

In addressing this issue, C&B suggests that new-found pressure to satisfy investor expectations may induce Premera to exit unprofitable markets, cut expenses, or take other steps that reduce the availability of insurance to potential customers. Cantilo Direct, pp.

[27] In the same paragraph, C&B states that "management and directors will certainly receive significantly higher compensation … ." Both the alleged certainty and the alleged magnitude of increased compensation, Mr. Cantilo has admitted, are merely assumptions. Cantilo Dep., 3/22/04, pp. 391-95.

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9, 66. Not only does this suggestion ignore the undisputed fact that the directors of a for-profit corporation have the same fiduciary duties as the directors of a non-profit corporation, as discussed above; it also assumes that Premera can only satisfy investors at the expense of its customers. Premera will succeed as a public company only to the extent that it continues to meet the changing needs of its customers and to attract new customers. BAS Report, pp. 13, 15.

If Premera takes steps that suggest indifference to the interests of its policyholders, they will vote with their feet. Far from pleasing investors, this will disappoint and anger them. If, conversely, Premera continues to improve the efficiency of its operations and to make investments in valued products and services, it will continue to grow, benefiting the insurance-buying public and rewarding investors, too. See generally discussion in Part I.D.2 above.

II. This Proceeding Is Not the Occasion for Resolving Issues Outside the Holding Company Act.

The Commissioner, in making his decision in this case, must apply the tests set forth in the HCA and, secondarily, the IHCA. Premera's proposed reorganization also raises issues that fall within the jurisdiction of other decision-makers. As the Commissioner has recognized, for example, the Director of the Alaska Division of Insurance has the task of examining the potential impacts of the transaction in Alaska and deciding whether it passes muster under that state's Holding Company Act.[28] Two other subjects deserve special mention here: The allocation of conversion proceeds between the states; and the extent to which, if at all, Premera's distribution of assets upon dissolution is subject to the restrictions of RCW 24.03.225(3).

[28] *See, e.g.*, Fourth Order; Twenty-fourth Order. *See also* Premera's Motion to Exclude Testimony on Alaska-Specific Issues.

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A. Allocation

The OIC Staff and its consultants have engaged in lengthy negotiations with their Alaskan counterparts over the respective percentages of Premera's assets that should go to the Washington Foundation and the Alaska Health Foundation. (Premera has not been involved in these discussions; on the contrary, it has been excluded.) Both states have an obvious interest in allocation.[29] Thus far, they have not been able to resolve it.

If the states cannot reach an agreement, the question arises whether the Amended Form A provides a means whereby the transaction can proceed while the allocation of proceeds is finally resolved. It does. Exhibit G-22, the Unallocated Shares Escrow Agent Agreement ("USEAA"), establishes a way to handle any shares that remain in dispute between the states. Premera's and the OIC Staff's experts agree that such a mechanism is necessary. Ex. S-4, p. 11; Steel Direct, p. 26; BAS Supp. Report, p. 10. The USEAA will not go into effect unless the States cannot agree upon their respective shares. The USEAA provides that the escrow agent will hold only the portion of shares that remain in dispute, and that the agent will distribute those shares and terminate the escrow whenever the states agree upon their allocation.

Absent an agreement between the states, the allocation issue cannot be finally determined in either this proceeding (where the ADI is not a party) or the Alaska administrative proceeding to follow (where the OIC is not a party). The United States Supreme Court is vested with exclusive jurisdiction to resolve disputes between states. U.S. Const. Art. III, § 2; 28 U.S.C. 1251(a); *Texas v. New Mexico*, 482 U.S. 124, 128 (1987) ("By ratifying the Constitution, the States gave this Court complete judicial power to adjudicate disputes between them …"). That authority appears to encompass questions

[29] That the states are both interested in the question is not to say that either of them is entitled to receive funds from Premera. The sole legal basis for their respective claims is the assumption that Premera's assets are charitable. The OIC Staff's consultants have not attempted to establish the validity of that assumption. *See* discussion in Part II.B. below.

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such as the one presented here. *See e.g., Texas v. Florida*, 306 U.S. 398 (1939). Therefore, the question of allocation is one solely for negotiation or, if that fails, for litigation between the states in another forum.[30]

B. Charitable Limitations upon Distribution of Premera's Assets and the Notion of "Fair Value"

Under the Washington Nonprofit Corporation Act, the Attorney General has authority to review plans for distribution of corporate assets upon dissolution to assure that certain assets—namely, those received and held by the corporation subject to limitations permitting their use only for charitable, religious, educational, or similar purposes—are properly transferred to organizations that are engaged in substantially similar activities. RCW 24.03.220 *et seq*. Among a nonprofit corporation's assets, there may be many, some, or none encumbered by such limitations.[31] The presence of charitable assets cannot be presumed; rather, there must be a clear showing both that the corporation's activities are charitable and that the donor of the assets intended that they be used only for charitable purposes. *See, e.g., Baarslag v. Hawkins*, 12 Wn. App. 756, 763-64, 531 P.2d 1283, 1287 (1975); *In re Multiple Sclerosis Serv. Org. of N.Y.*, 496 N.E.2d 861, 864 n.5 (N.Y. 1986); *City of Fort Payne v. Fort Payne Athletic Ass'n*, 567 So.2d 1260, 1264 (Ala. 1990).

Assets of a non-profit corporation that are neither required to be returned nor encumbered by charitable restrictions may be distributed as follows:

> (4) Other assets, if any, shall be distributed in accordance with the provisions of the articles of incorporation or the bylaws … .;

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[30] The absence of an allocation agreement between the states does not afford any basis to delay or deny approval of the Form A, either under the standards in the HCA or otherwise.

[31] Receipt of assets that are subject to explicit charitable limitations does not render the recipient corporation, or all of its other assets, charitable. *See, e.g., Health Midwest v. Kline*, No. 02-CV-08043, 2003 WL 328845, at *26 (Ken. Dist. Ct. Feb. 6, 2003).

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> (5) Any remaining assets may be distributed to such persons, societies, organizations or domestic or foreign corporations, whether for profit or not for profit, as may be specified in a plan of distribution … .

RCW 24.03.225.[32] Asked about this provision, Mr. Cantilo testified as follows:

> Q: And the board would presumably have to follow what its articles of incorporation and bylaws said about the distribution upon dissolution, would it not?
>
> A: Once again, you'd have to look at the articles and bylaws of the company to know whether the board, under some circumstances, might be excused from adhering to those provisions.
>
> Q: Assuming that the board does adhere to those provisions, Mr. Cantilo, is there any legal constraint or external constraint on the board in making a choice among potential recipients of such assets?
>
> A: Assuming that no such constraint arises from the way in which the assets were first conveyed to the corporation and that no such constraints arise from the organizational documents?
>
> Q: Correct.
>
> A: I know of none sitting here today.

Cantilo Dep., 3/10/04, pp. 56-57.

Applying RCW 24.03.225 in accordance with its terms, therefore, may require a determination as to which, if any, of a nonprofit corporation's assets were received and held subject to limitations permitting their use for charitable purposes alone.[33] Only the Attorney General or a court of competent jurisdiction may determine the extent to which

[32] For example, a non-profit corporation may, in its plan of distribution, provide for some or all of its assets to go to charity. That does not render the non-profit corporation or its assets (prior to distribution) charitable. As Mr. Cantilo acknowledged, a for-profit corporation could do the same thing. Cantilo Dep., 3/10/04, p. 53.

[33] A similar inquiry is required before the Attorney General can apply common-law charitable trust doctrine. *See* Pre-Filed Direct Testimony of John Steel, pp. 2-3. The Attorney General has not undertaken such an inquiry, but rather merely assumed that all of Premera's assets are charitable. *See* email attached to the Pre-Filed Responsive Testimony of John Steel. Such an assumption (which appears to underlie, for example, the memorandum to C. Gregoire dated October 22, 2002) has no force of law.

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RCW 24.03.225(3) applies or does not apply to the assets of a nonprofit corporation. RCW 24.03.230. Such a question does not lie within the authority of the Commissioner to resolve. *See Inland Foundry Co., Inc. v. Spokane County Air Pollution Control Auth.*, 98 Wn. App. 121, 124, 989 P.2d 102, 103 (1999) ("An administrative review board has only the jurisdiction conferred by its authorizing statute.").

Even if the question of charitable restrictions upon Premera's assets were properly before the Commissioner, there would be no basis on this record to conclude that Premera's assets are so encumbered. Premera is not a charity; it is a taxable provider of health care coverage to those who pay premiums for such coverage. *See* Pre-Filed Direct Testimony of John Steel, pp. 6-10, 13-15; Pre-Filed Responsive Testimony of Gubby Barlow, p, 2; Pre-Filed Responsive Testimony of John Steel, p. 1-3 & n.2. Premera does not solicit or receive charitable contributions, and it does not provide free or reduced-fee services to the indigent. Barlow Resp., p. 2. It is a commercial enterprise. Congress recognized this fact when, in 1986, it withdrew the tax exemption previously enjoyed by Blue plans. *See* Report of E. Lewis Reid (11/10/03), pp. 4-5 & n. 7.

Although the Intervenors attempt to suggest otherwise, Washington nonprofit corporations are not presumed to be charitable. A host of nonprofit corporations in this state are not charities. "Corporations may be organized under this chapter [24.03] for any lawful purpose or purposes, including . . . professional, commercial, industrial, or trade association … ." RCW 24.03.015. Nonprofit status "does not alone make a corporation benevolent or charitable." *Adult Student Hous. v. Dep't of Rev.*, 41 Wn. App. 583, 593, 705 P.2d 793, 798 (1985). A nonprofit corporation "is not a charitable trust. As a corporation, its powers are defined by RCW 24.03." *Adolescent Treatment Svcs. v. Ahvakana*, No. 42175-1-I, 1999 WL W34515, at *3 (Wn. App. Nov. 15, 1999)

Under Washington law, only nonprofit corporations that are tax exempt under 26 U.S.C. 501(c)(3) may hold themselves out "as operating to benefit the public." RCW

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24.03.005(14) (adopted in 1989). Because it has never been tax-exempt under section 501(c)(3), Premera cannot qualify as a public benefit nonprofit corporation under Washington law. *See* RCW 24.03.490. And while the Acquisition of Nonprofit Hospitals statute, RCW 70.45 *et seq.*, presumes that non-profit hospitals are charitable and requires that the value of their assets be transferred to charitable organizations if they convert to for-profit status, there is no similar presumption or requirement under the Holding Company Act for a health care service contractor. *See* Steel Direct Test., pp. 10-13; Part III.A. below.

Rather than investigating the extent to which, if at all, Premera's assets are encumbered by charitable limitations, the OIC Staff's consultants simply assumed that Premera was a charitable corporation and based their analysis upon that assumption—nothing more. As Mr. Cantilo testified:

> [W]e made the parting assumption in this analysis that the question of whether or not Washington - I'm sorry, Premera Blue Cross or Premera has a charitable obligation to Washington and Alaska is not one that is a subject of debate, that that's one on which the parties have made the common assumption. So we have not spent time in this or any other analysis looking into that issue. Whether or not that comports with experience in other states would not have been relevant.
>
> Q: I understand your point, then. You simply made the assumption and not troubled yourself greatly to analyze how the assumption might be informed or not informed by what happened elsewhere?
>
> A: Well, we have not been asked to do that.

Cantilo Dep., 3/10/04, pp. 38-39.[34] Mr. Cantilo testified further as follows:

[34] From its initial notice to the Commissioner to the present, Premera has consistently taken the position that it and its predecessor companies "were not established or operated as charitable institutions … ." Letter dated May 30, 2002, from G. Barlow and Y. Milo to Mike Kreidler, p. 2; Letter dated May 30, 2002, from G. Barlow and Y. Milo to Christine Gregoire, p. 2. Mr. Cantilo has acknowledged this:

> Q: Has Premera ever stated either publicly or privately to you or in your presence that its value must be paid to the public as part of the conversion?

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Q: When we were last together, Mr. Cantilo, we discussed the assumption that is set forth explicitly in Exhibit 2 to your deposition, namely, your operating assumption that the assets of Premera are all deemed to be charitable. And you told me that Mr. Hamje had orally instructed to you make that assumption; is that right?

A: Yes.

Q: Did you understand Mr. Hamje's instruction to relate solely to the question of allocation, which is the subject matter of this Exhibit 2?

A: I'm sorry. Before I answer this question, I should clarify my answer to the prior question. You characterized the issue as treatment of all of the assets as charitable. The way in which we discussed the issue was an obligation on Premera's part to convey the equivalent of its full fair market value to the foundations. In that sense, we were advised by Mr. Hamje to make that assumption. I cannot recall whether we ever discussed that assumption as being attributable to an underlying assumption that the assets were all charitable in nature. I think our discussions generally were simply mechanical in the sense that we should assume that the transaction would require that all of Premera's fair market value be conveyed to the foundations.

Q: My follow-on question, Mr. Cantilo, was whether you understood Mr. Hamje's instruction to relate solely to the question of allocation, that is, to the division of Premera's assets between Washington and Alaska. Or was it more broad than that?

A: I did not understand it to relate solely to allocation.

Q: That assumption, same assumption, underlies the analysis in both your original report and your supplemental report in this case, does it not?

A: I believe that's true.

Q: If we look at pages 62 and 63 of your supplemental report, for example, you address here the restrictions upon the foundations that you say are part of the voting trust agreement and other stock governance agreements. And at the bottom of page 62 and continuing over to page 63 you refer to the, quote, "fundamental

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A: I don't recall Premera stating that in my presence.

Cantilo Dep., 3/10/04, p. 27.

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clash of these restrictions with the basic premise that PREMERA belongs to the public in the first instance." Do you see that?

A: Yes.

Q: That basic premise which you refer to here is the same assumption that we've just been discussing, is it not?

A: I think it's a very closely related assumption if it's not exactly the same assumption.

Q: Now, if that assumption is not made in this case, Mr. Cantilo, would you agree with me that one can complain about the restrictions upon the foundations that exist by dint of the stock governance agreements because they reduce the value that the foundations would otherwise receive, but you could not argue that this reduction in value violates any legal requirement applicable to the transaction; isn't that right?

A: You mean if we make the assumption that there's no requirement that the full fair market value of the company be transferred?

Q: Yes.

A: Assuming that there is no legal requirement quantifying the magnitude of the transfer, I think your statement is correct.

Q: Now, you testified earlier that you asked Mr. Hamje whether you were being asked to analyze whether or not Premera had a charitable-trust obligation to distribute its assets to the citizens of Washington and Alaska. He said no; is that right?

A: That's my recollection.

Q: And on that basis, you did not investigate the extent to which at all Premera's assets are subject to a charitable trust; is that right?

A: That's correct.

Cantilo Dep., 3/22/04, pp. 280-83.

Assistant Attorney General Fallis, in email exchanges with Mr. Cantilo, expressed "considerable uncertainty" about whether Premera was a charitable corporation. Cantilo Dep., 3/22/04, p. 300. Mr. Cantilo, for his part, said that he was "concerned that the organizational documents may not impose on PREMERA nearly as inviolable a charitable obligation as one typically finds in more traditional public benefit

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organizations." *Id.* at 298. Both wished to avoid the question. *Id.* at 294. Mr. Cantilo's associate wrote:

> Furthermore, I doubt the OIC or AG would want to be put in a position where it would have to publicly admit that charitable trust law may not apply for a variety of reasons including the fact that the underlying theory by [sic] behind the foundation's receipt of the nonprofit assets' FMV [fair market value] is cy pres.

Id. at 295. Mr. Cantilo admitted that, if his assumption is invalid, much of his analysis has no support whatever:

> Q: At any point during your work on this project, Mr. Cantilo, did you consider the consequences of making a different assumption about the supposed legal obligation on the part of Premera to dedicate 100 percent of its assets to charitable purposes?
>
> A: Yes.
>
> Q: And when did you consider that?
>
> A: Probably from the very beginning.
>
> Q: Can you describe for me what consequences you considered?
>
> A: I can't tell you, Mr. Mitchell, that I considered specific consequences. But I understood and, at least in internal discussions within our firm, expressed a view that some concerns articulated in our reports about the proposed structure of the transaction would have a lot less merit or no merit at all if there were not a requirement for the conveyance of a specific consideration or value by Premera to the foundations as part of the conversion.
>
> * * *
>
> Q: And which aspects of your report would have a lot less merit under those circumstances?
>
> A: If we were to assume that applicable law does not require that Premera convey any specific or determinable amount of assets to a foundation, criticisms of the impact of stock restrictions in reducing the value of the assets transferred would on that ground be inapplicable. That's an illustration; I did not mean to give you a comprehensive list.

Id. at 287-88.

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As Mr. Cantilo admitted, "Our assumption has no force of law." *Id.* at 288. Washington courts agree: expert opinions must be based on facts, and "opinions based on assumptions are not sufficient." *Rogers Potato Serv., LLC v. Countrywide Potato, LLC*, 119 Wn. App. 815, 820, 79 P.3d 1163, 1166 (2003). "An opinion of an expert which is simply a conclusion or is based on an assumption is not evidence … ." *Theonnes v. Hazen*, 37 Wn. App. 644, 648, 681 P.2d 1284, 1286-87 (1984).

Apart from the potential application of RCW 24.03.225(3) (or its common-law analogue) to Premera's current assets—something that has not been established and cannot be established in this proceeding—there is no obligation on Premera's part to convey anything to any charity.[35] Although the OIC Staff's consultants refer to "fair value" or "fair market value" from time to time, neither concept can be found in the HCA standards that govern evaluation of Premera's Amended Form A.[36]

For the foregoing reasons, all of the assertions in the C&B reports and in Mr. Cantilo's testimony that the Amended Form A does not comply with applicable legal standards, which are based on the premise that Premera is a charity and/or that fair market value has not been transferred to the foundations, cannot serve as a basis to disapprove the Amended Form A or to impose conditions upon approval. The assertions and conclusions in the C&B reports that are based upon those assumptions include those

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[35] Even if it could be shown that some of Premera's assets were received subject to explicit limitations permitting their use only for charitable purposes, the conversion transaction as set forth in the Amended Form A meets the requirements of RCW 24.03.225(3). *See* Steel Direct, pp. 15-17.

[36] An October 2002 memorandum to Attorney General Christine Gregoire may be the source of confusion here. That memorandum mixes the factors set forth in RCW 48.31C.030(5)(a) (governing Form A acquisitions) with a standard found in RCW 48.31C.050, which applies to Form D transactions. Transactions within a holding company system—Form D transactions—are subject to specific requirements, such as "fair and reasonable" terms, charges, and fees. RCW 48.31C.050(1). As noted in RCW 48.31C.050(4), such requirements apply to transactions described in RCW 48.31C.050(2). The latter provision specifically excepts "those transactions which are subject to approval by the commissioner elsewhere within this title," such as Form A transactions.

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listed in Appendix C hereto. None of the C&B conclusions in Appendix C can provide a proper basis upon which to disapprove the Amended Form A or to impose conditions of approval.

III. Much of the Analysis and Many of the Conclusions of the OIC Staff's Consultants Have Nothing to Do with the Standards in the HCA.

Mr. Cantilo admitted in his deposition that a strict interpretation of the HCA would not prohibit Premera's proposed conversion:

> Q: Can you explain, please, the statement in the second sentence of Mr. Taktajian's e-mail to you – I'm sorry. Third sentence – that "a strict interpretation of the Holding Company Acts would not prohibit the transaction"?
>
> A: I'm not sure what explanation you need. I think that's probably a correct statement.

Cantilo Dep., 3/22/04, p. 350. Sticking to the standards set forth in the HCA would have made the reports of the OIC Staff's consultants much shorter. Wide-ranging discussions on other matters, even if they were accurate, are not relevant to the issues before the Commissioner.

A. The Acquisition of Nonprofit Hospitals Statute Has No Application to This Proceeding.

The C&B reports devote a great deal of attention to RCW 70.45, the Hospitals Statute. C&B attempts to apply the Hospitals Statute by analogy to this proceeding[37]; it then applies the standards in that statute as if they governed Premera's proposal.[38] C&B does so despite having been warned by the Attorney General's office as follows:

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[37] C&B admits that there is no Washington precedent for its analysis of many issues. It states: "Due to the paucity of specific case law in this and other jurisdictions, as well as the unique nature of the issues to be opined upon, a substantial portion of C&B's Analysis is based on analogous statutes and case law from this and other jurisdictions … ." Ex. S-33 (Ex. Summ.), p. 4. Mr. Cantilo has acknowledged that the only Washington statute that he sought to treat as analogous was the Hospitals Statute. Cantilo Dep., 3/22/04, pp. 397-98.

[38] Many errors in C&B's analysis can be traced to this source. For example, the HCA requires an evaluation of the objective impacts of a proposed acquisition, whereas the Hospitals Statute focuses upon the process that led up to an acquisition and the subjective

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> I don't think I would want to cite specifically to 70.45 in our analysis, as there are some potentially unfavorable (to the regulators) comparisons to be made. Rather, … I think that 70.45 provides a good internal point of reference as we analyze the proposed conversion.[39]

In support of its attempt to apply the Hospitals Statute here, C&B cites the doctrine of *in pari materia* (which means, roughly, that statutes addressing the same subject matter should be read together). The very case C&B cites (*see* C&B supplemental report, p. 43 n.102) demonstrates that this doctrine cannot be invoked to apply the Hospitals Statute in this case.[40] In *Hallauer v. Spectrum Properties, Inc.*, 143 Wn.2d 126, 18 P.3d 540 (2001), the Washington Supreme Court held that *in pari materia* could not be used to import the standards of one statute into another, even though both statutes dealt in general with condemnation of property for an easement. Plaintiff landowners wanted to transport water from a neighboring well across the defendants' property and sought to condemn part of defendants' property for this purpose. *Id*. at 129. Under RCW 90.03.040, the plaintiffs could exercise the right of eminent domain "to acquire any property… *when found necessary for*… the application of water to any beneficial use." *Id.* at 134. (emphasis added) (citations omitted). The lower court defined this "necessity" requirement by importing the standard from RCW 8.24.010, governing condemnation of rights of way for landlocked land. *Id.* at 131. Under this standard, the lower court denied the plaintiffs' condemnation claim on the basis that their land was not landlocked. The Supreme Court rejected the lower court's use of *in pari materia*:

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motivations of the participants. C&B devotes extensive analysis to the latter factors, despite the fact that they have nothing to do with HCA standards. Equally irrelevant under the HCA is C&B's discussion of due diligence by the Premera Board and so-called *Revlon* duties. The Premera Board's performance in this case is beyond reproach. *See* Steel Direct, pp. 17-21. But the C&B reports improperly divert attention from HCA factors to non-HCA ones.

[39] Email from R. Fallis to P. Cantilo, 1/31/03.

[40] The Attorney General's office informed Mr. Cantilo that there was no authority for applying *in pari materia* in these circumstances. Cantilo Dep., 3/10/04, pp. 45-46.

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> Although the goal is to read statutes related to the same subject together if possible, there is an obvious conflict between the statutes where rights of way to transport water are concerned. RCW 90.03.040 is the more specific of the statutes regarding condemnation for transportation of water and is also the later of the enactments. These two factors indicate that insofar as the statutes conflict, RCW 90.09.040 prevails… [RCW 8.24.010] cannot apply… to preclude condemnation of rights of ways to transport water as authorized by RCW 90.03.040.

Id. at 147.

In this case, the HCA specifically applies to the acquisition of non-profit healthcare insurers such as Premera, whereas RCW 70.45 does not apply to non-profit healthcare insurers at all. That alone is sufficient basis to reject application of *in pari materia*. *See State v. Anaya*, 95 Wn. App. 751, 760, 976 P.2d 1251, 1256 (1999) ("in pari materia analysis is not appropriate here because there is only one legislative enactment that applies in Anaya's case."); *Riksem v. City of Seattle*, 47 Wn. App. 506, 510, 736 P.2d 275, 277 (1987) ("The doctrine of *in pari materia* speaks when there are more than one legislative enactment which could apply."). Finally, the HCA is the later of the enactments. The HCA was enacted in 2001; RCW 70.45 was enacted in 1997. In accordance with the Supreme Court's holding in *Hallauer*, C&B cannot legitimately import the standards from RCW 70.45 to the HCA.

This conclusion is only strengthened if one looks at legislative history. The Washington Legislature based the Hospitals Statute on drafts of the NAAG Model Act for Nonprofit Healthcare Conversion Transactions (the "NAAG Model Act"). The NAAG Model Act applied to both nonprofit hospitals and nonprofit healthcare insurers. In marked contrast to the NAAG Model Act, the Washington Legislature decided to exclude nonprofit healthcare insurers such as Premera from the scope of RCW 70.45.[41] Thus, there is a strong presumption that the Legislature intended the provisions of the Hospitals Statute, including its charitable trust-like restrictions, would not apply to non-profit

[41] *See* Steel Direct, pp. 10-13.

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healthcare insurers. *See Lundberg v. Coleman*, 115 Wn. App. 172, 177-78, 60 P.3d 595, 599 (2002) ("when the model act in an area of law contains a certain provision, but the Legislature fails to adopt such a provision, our courts conclude that the Legislature intended to reject the provision."); *cf. Beckman v. Wilcox*, 96 Wn. App. 355, 365, 979 P.2d 890, 895 (1999) (rejecting application of *in pari materia* because "[t]he two statutes have different legislative histories and different public policies support them.").

B. The Economic Viability of the Washington Foundation Is Not Relevant Under the HCA.

C&B states that the economic viability of the transaction is appropriately defined initially by whether Premera is likely to have a successful IPO. The investment banking experts agree that Premera will be an attractive investment. Jonathan Koplovitz of Blackstone, for example, testified as follows:

> Premera, based on what we've seen is a good candidate to do a public offering. It seems it's about the right size. It seems - has a lot of attractive qualities. It's had a good growth trajectory over the last few years. The market for these companies is still pretty good

Koplovitz Dep., 11/20/03, p. 130. *Accord* Kinkead Direct, p. 6 ("Premera's rationale and performance metrics should satisfy investor expectations … and therefore, it should be viewed as an attractive investment."). Premera is strong on the fundamentals, and the market has familiarity with such transactions. BAS Supp. Report, pp. 6, 13; Alderson Smith Dep. 11/25/03, p. 307.

C&B suggests, however, that "economic viability" should also focus upon the foundations and the adequacy of the "consideration" that Premera proposes to give them. Ex. S-31, pp. 24-26; Ex. S-33, pp. 12-13. Here C&B not only leaves behind the standards of the HCA[42]; it also presumes, wrongly, that Premera has a legal obligation to convey a

[42] The attorneys at C&B privately questioned the relevance of "economic viability." Cantilo Dep., 12/1/03, pp. 128-30 and Ex. 16. One of them pointed out that "economic viability" is "not a statutory term. Such a standard could be attacked on appeal as vague and arbitrary, with no basis in law, etc." *Id.* at 129. Another agreed with this assessment.

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certain amount to charity. As Mr. Cantilo has admitted, this is a pure assumption, the validity of which he has not attempted to establish. It has no force of law.

C. Controls on Cash Compensation and Incentives Proposed by the OIC Staff's Executive Compensation Consultant Are Not Contemplated by the HCA.

In addition to controls on the proposed equity incentive plan, Donald Nemerov, the OIC Staff's compensation consultant, makes a number of observations reflecting his business judgments and/or personal preferences about constraints that he would like to impose on particular details of Premera's post-conversion executive compensation programs. In effect, Mr. Nemerov seeks to substitute his judgment for that of Premera's Board and Compensation Committee. For example, he recommends establishing a minimum shareholder return before any payment is triggered under Premera's Long-Term Incentive Plan,[43] a suggestion that Mr. Furniss, Premera's executive compensation expert, does not believe would "be in the best interests of Premera's constituents, and strongly recommend[s] against." Towers Perrin Supp. Report, p. 6.

This type of rigid rulemaking by Mr. Nemerov is wholly inappropriate. First, it flies in the face of best practices for executive compensation. Premera's executive compensation plans are governed by a Compensation Committee composed entirely of outside board members advised by an independent compensation consultant that reports directly to the Committee. As Mr. Furniss testifies, "there is every reason to conclude that Premera's post-conversion compensation for its executives will be reasonable and appropriate." Furniss Direct, p. 1.

Second, Mr. Nemerov's rulemaking is not contemplated by the HCA. Indeed, it is contrary to the interests of Premera's policyholders, which is the touchstone for HCA review. As Mr. Furniss concluded:

[43] Pre-Filed Nemerov Resp., p. 22; Ex. S-29, p. 4.

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> Mr. Nemerov would seek to impose rigid rules that try to predict today what will be needed a year or two years from now. I argue that such rigid rules are a bad idea because the market place changes very quickly and what seems like a good requirement now may be either too restrictive in the future or too lenient. The problem, of course, is that, in either event, Premera may not be able to provide the appropriate pay levels for its executives, to the detriment of the company and ultimately the policyholders and the shareholders. Better, I say, for the Compensation Committee and the Board to have the flexibility to take into consideration the points made by Mr. Nemerov in making their independent judgment but not to be handcuffed by those points.

Furniss Resp., p. 3 (emphasis added).

D. The Necessity of Conversion is Not a Factor Under the HCA.

The last paragraph of C&B's supplemental report intones that "PREMERA overlooks one fundamental problem. It has not demonstrated a compelling need for change, let alone for this transaction." Ex. S-33, p. 92. On this basis, C&B would consign Premera's proposal to oblivion. C&B's charge is fundamentally misguided.

As Premera has explained in detail, it has valid and important reasons for seeking conversion, and this is the right time to move forward. The investment banking experts agree. Kinkead Direct, p. 5; Kinkead Resp., p. 6; Koplovitz Dep., 11/21/03, p. 269; Alderson-Smith Dep., 11/25/03, p. 257. C&B is manifestly unqualified to evaluate Premera's business rationale or to second-guess the decisions of Premera's Board. But even if this were the case—even if C&B's conclusion were valid—the statement would deserve no weight in this proceeding. For, as Mr. Cantilo admitted at his deposition:

> Q: Where in the Holding Company Act, Mr. Cantilo, is there a requirement that the applicant demonstrate a compelling need for the transaction for which it seeks approval?
>
> A: There is no such requirement.

Cantilo Dep., 3/22/04, p. 275.

IV. The Commissioner Should Not Give Significant Weight to the C&B Reports.

The C&B reports have drawn special attention in this proceeding because they purport to draw together the findings of other consultants and to tie those findings to the

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legal standards for decision.[44] But those reports also pose special dangers. They, like the anticipated testimony of Patrick Cantilo, deserve scant weight.

A. The Authors of the C&B Reports Lack Expertise in Key Areas.

The authors of the C&B reports are lawyers who are accustomed to acting as advocates for their clients. They do not have expertise in the subject areas addressed in their reports. Mr. Cantilo admitted that he is not an expert on matters of tax, tax-exempt organizations, actuarial science, investment banking, executive compensation, corporate governance, or antitrust:

- He has no education or training in tax law (other than a single course in personal income taxation). Cantilo Dep., 12/1/03, p. 8. He is not a tax lawyer or a tax expert. *Id.*, pp. 51, 193.
- He has no education or training in the area of tax-exempt organizations. *Id.* at 8.
- He has no education or training in investment banking. *Id.*
- He has no education or training in actuarial science. *Id.*, p. 9.
- He has no education or training in executive compensation. *Id.*
- He has no education or training in the area of nonprofit corporate governance. *Id.*
- He has some experience in antitrust, securities, and corporate transactions but would not consider himself an expert in those areas. *Id.*, pp. 9-10.

Mr. Cantilo's associate, Andrew Taktajian, was responsible for much of the drafting of the C&B reports. *Id.*, p. 28; Cantilo Dep., 3/10/04, pp. 59-61. Mr. Taktajian, who was born in 1975, graduated from law school in 2001 and was admitted to the Texas bar in 2002. Mr. Taktajian has not received any specialized training in any of the areas identified above. Cantilo Dep., 12/1/03, pp. 19-20.

With an almost complete lack of training or experience, not to mention expertise, in any of these substantive areas central to the Premera transaction, the authors of the

[44] Despite warnings that the C&B reports should be read together with other reports by the OIC Staff's consultants, there is a danger that readers may stop with C&B's conclusions. This is a particular problem where C&B colors or distorts what it ostensibly reports.

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C&B reports are not qualified to offer "expert" opinions regarding these aspects of the transaction. In the C&B reports, however, Mr. Cantilo and Mr. Taktajian frequently superimpose their views upon and alter the opinions of the true experts. For this reason, among others, the Commissioner should exercise great caution in considering C&B's characterizations of the findings of other consultants.

B. The Authors of the C&B Reports Are Not Experts in Washington Law.

Neither Mr. Cantilo nor Mr. Taktajian is licensed to practice law in the state of Washington. *Id.*, p. 33. Mr. Cantilo's deposition testimony established that:

- Mr. Cantilo is not familiar with the Washington Nonprofit Corporations Act provision defining public benefit corporations in Washington state. *Id.*, p. 70.
- There are Washington lawyers who are more familiar with the statutes at issue and who have greater experience than the members of his firm. *Id*., p. 50. In relation to the applicable Washington statutes, Mr. Cantilo believes there are Washington attorneys who have been "working this area much longer than we have … who apparently hold firmly views different from ours." *Id.*, p. 51.
- Mr. Cantilo did not talk to any Washington lawyer other than his contacts at the OIC and AG's office when preparing opinions on matters of Washington law. *Id.*, p. 36.

In a licensed field, "the law presumes that licensed witnesses are experts and nonlicensed witnesses are not." *Kelly v. Carroll*, 36 Wn.2d 482, 491, 219 P.2d 79, 84 (1950). To the extent that Mr. Cantilo's expertise as a Texas lawyer entitles his testimony to consideration at all, his testimony must be limited to his area of expertise. *Id*. If he strays from his recognized area of expertise—by, for example, testifying as to what he believes is in the "public interest" for the state of Washington—the Commissioner should disregard such testimony. *Queen City Farms, Inc. v. Cent. Nat. Ins. Co. of Omaha*, 126 Wn.2d 50, 99, 882 P.2d 703, 729-30 (1994); *Boeing Co. v. Sierracin Corp.*, 108 Wn.2d 38, 50-51, 738 P.2d 665, 675 (1987); *Dobias v. W. Farmers Ass'n*, 6 Wn. App. 194, 197, 491 P.2d 1346, 1348 (1971).

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C. C&B Has Acted as an Advocate, Not as an Expert.

The purpose of expert testimony is to explain complicated facts objectively, so that a decision maker can understand the facts and apply them to the governing law. For this reason, an expert witness should avoid acting as an advocate and should not allow personal biases to influence the interpretation of facts. This is especially true of expert witnesses who are lawyers. An expert witnesses should not engage in the dual roles of witness and advocate, for that reduces the likelihood of his being an objective witness. An attorney acting in this double capacity is viewed with extreme disfavor. *United States v. Morris*, 714 F.2d 669, 671 (7th Cir. 1983) ("That counsel should avoid appearing both as an advocate and witness … is beyond question.").

In this case, C&B functioned repeatedly as an advocate, not just a witness, for the OIC Staff. Mr. Cantilo and Mr. Taktajian (1) analyzed Premera's privilege logs and drafted legal arguments for the OIC Staff to use in attacking Premera's assertion of attorney-client privilege; (2) briefed an argument that the Blue Cross/Blue Shield trademark is owned by the public; (3) helped the OIC Staff draft responses to the Commissioner's orders; (4) provided an analysis of Premera's petition for judicial review, and (5) drafted rebuttals to Premera's arguments regarding the petition for judicial review. *See* Cantilo Dep., 12/1/03, pp. 142-43; Cantilo Dep., 12/2/03, pp. 419-22.

Mr. Cantilo acknowledged that he had acted in a role comparable to what counsel for the OIC Staff would do—namely, assisting Mr. Hamje in advocacy. *Id.*, p. 422. He also said that he appreciates Mr. Taktajian's "creativity as an advocate." Cantilo Dep., 3/22/04, p. 352. Mr. Cantilo testified: "I'm not so naïve as to think that my biases and the biases of other people in my firm did not find their way into [our] reports … ." Cantilo Dep. 12/1/03, p. 146. Neither should the Commissioner harbor any such illusions.

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The C&B reports do not present an objective or a neutral evaluation of Premera's proposal, as they should. Rather, they reflect the advocacy of their authors.[45] Examples include the following:

- To describe an award of stock options that was viewed by other consultants as consistent with those in similar transactions, and an award that Mr. Cantilo did not believe was excessive, he chose the phrase, "Not Grossly Excessive." Cantilo Dep., 12/2/03, pp. 254-55.
- C&B used the phrase, "specter of a conflict of interest," to describe the "*possibility*" that one *might* exist. *Id*. at 360. Mr. Cantilo chose this language despite the fact that, after interviewing the management of Premera regarding this issue, he could not recall any answer that would indicate the presence of a conflict. *Id*., p. 242-43.
- The Blackstone report lists more positives than negatives associated with a potential Premera IPO, and it devotes eight pages to explaining why those positive factors are so important. Mr. Cantilo, however, refers only to the negatives listed in the Blackstone report. Cantilo Dep., 12/1/03, pp. 147-49.

Perhaps more disturbing, the authors of the C&B reports sought repeatedly to have the other OIC Staff consultants word their reports more negatively. *See* Cantilo Dep., 12/1/03, pp. 153-66 and Ex. 22. For example, Mr. Taktajian advised Blackstone to eliminate a statement that Premera's significantly lower RBC "could impair its ability to fund required capital investments over the long term." Cantilo Dep., 12/1/03, p. 158. In another message, he said that he was looking for language that would be "more defensible if the commissioner disapproves the transaction." *Id.* at p. 161.

For all these reasons, the C&B reports and associated testimony should be given little weight in the Commissioner's evaluation of the evidence.

[45] Premera is hardly alone in noting a hostile tone in C&B's writing. Mr. Hamje pointed out early in this process that a brief filed by C&B in another proceeding was "strident" and "highly partisan," tending toward "confrontation." Email from J. Hamje to J. Odiorne, 9/19/02 (document produced in discovery to Premera by the Intervenor Group Premera Watch Coalition). The Oregon Attorney General, reacting to the legal opinion that is Ex. S-35, expressed frustration with its tone and called it an "adversarial brief." Letter to R. Fallis from R. Laybourn, 2/24/04.

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V. Premera's Amended Form A Reflects a Host of Changes to Address Issues Raised in the Original Reports by the OIC Staff's Consultants. The Concerns They Now Express Do Not Merit Further Changes.

A. Introduction

The parties have made significant progress in narrowing the issues in dispute related to the documents governing this transaction.[46] Nonetheless, there remain outstanding issues related to the transaction documents, as discussed below.

A common theme underlying the open issues is the belief of the OIC Staff's consultants that the foundations should have the maximum amount of flexibility and independence in voting and selling Premera shares, as well as governing themselves and New PREMERA after the conversion. Such flexibility, independence, and control are required, the consultants assert, because Premera holds its assets for the public benefit.[47] On that basis, the consultants assert that the transfer of 100% of the initial stock of New PREMERA is not enough: rather, the transfer must convey "fair value" or "fair market value."[48] As explained above, this assertion rests upon the consultant's misapplication of the charitable trust doctrine which is based on an unsupported assumption, and an erroneous application of the "fair value" test, which is not part of the standards under the HCA and thus not relevant to the Commissioner's review.

B. Role of Precedent Transactions

If we assume, for the sake of argument only and without conceding the point, that Premera is required to transfer stock having "fair value" or "fair market value" to the foundations upon closing of the conversion, then it may be appropriate to compare the Form A transaction documents with those used in prior conversions. Such a review shows

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[46] Premera believes its original Form A Statement complied with the standards under the HCA. However, Premera amended its Form A in response to comments from and discussion with the OIC Staff's consultants.

[47] Exhibit S-33, pp. 12, 50.

[48] *Id.*

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that Premera's Amended Form A is very much in line with previous transactions.[49] Any further modification intended to give the foundations the consultants' suggested additional flexibility could have a detrimental effect on the value of the shares that they are to receive. This is true for three reasons:

1. Premera's proposed transaction structure and terms are similar to the structure and terms of previous successful equity offerings by converted BCBS plans, including WellPoint, RightCHOICE and WellChoice and, on that basis, are likely to be acceptable to investors.[50] The OIC Staff's own investment banking consultants agree.[51] The transaction structure includes provisions to minimize the potential adverse impact of the foundations on the Company's operations and stability (or market concerns about such an impact) and to provide for an orderly and predictable divestiture of the New PREMERA stock held by the foundations, both of which are important to investors.[52] Further modifications that give the foundations more flexibility will not increase the value of the stock transferred to them and will jeopardize Premera's BCBSA license.[53]
2. The transaction documents, as structured, reflect the outer limits of what the BCBSA will agree to in approving exceptions from its licensure requirements.[54] Therefore, any further deviation from the precedent transactions could place Premera's ability to use the Blue marks at risk,

[49] Kinkead Resp., Exhibit B.
[50] Kinkead Direct, pp. 7-8.
[51] Kinkead Resp., p. 2, Ex. A..
[52] *Id.*
[53] BAS Supp. Report, p. 8.
[54] Barlow Direct, pp. 18-20; *see also* Marquardt Direct, pp. 24-25.

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thereby significantly diminishing the value of the company.[55] The investment banking experts have recognized that the New PREMERA stock held by the Foundations and other shareholders is significantly more valuable with the Blue marks than it would be if Premera lost the right to use such marks.[56]

3. Premera has made significant revisions to the transaction documents that were originally filed in 2002. The revisions have brought the transaction documents into line with the precedent transactions, most notably WellChoice. The OIC Staff's consultants have, on numerous occasions, told Premera that the WellChoice transaction is the "best of breed."[57] Nearly all of the issues that the consultants deem outstanding would, if accepted by Premera, go beyond WellChoice and the other precedent transactions.[58] Moreover, they are nothing more than an attempt by the consultants to exact greater concessions, even though the provisions they seek add little or no appreciable value to the New PREMERA stock to be held by the Washington Foundation, the entity the consultants purport to be protecting.[59]

C. Blue Cross Blue Shield Association Issues

To maintain its license to use the BCBSA mark, one of the premier brands in the industry, Premera must comply with the terms of its license agreements with BCBSA.[60]

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[55] Kinkead Direct, pp. 8-9.

[56] *Id.*

[57] Kinkead Resp., p. 12, Ex. A.

[58] *Id.*

[59] The consultants' concern about protecting the foundations at the expense of policyholders is misguided, given that the HCA requires the Commissioner to focus upon the welfare of subscribers.

[60] Amended Form A, Exhibit G-20; *see* Reid Resp., pp. 6-7; Barlow Direct, pp. 17-20.

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Among those terms is the requirement that no non-institutional investor may own more than 5% (less one share) of the stock of a BCBSA licensee.[61] Any deviation from this license requirement can be waived only with the approval of the BCBSA Board and its Member Plans.[62] Waivers have been approved in prior conversions on a temporary and case-by-case basis, and the BCBSA, under its license agreement, can and does impose conditions on such waivers.[63] The BCBSA staff has informed Premera that the BCBSA will not approve the licensure deviation if the proposed transaction contains several of the conditions suggested by the OIC Staff's consultants.[64]

The OIC Staff's consultants have raised concerns with the Amended Form A and have proposed changes in the transaction terms that directly conflict with the BCBSA's requirements. The proposed changes include the following:

- The Washington Foundation and Alaska Foundation each should be able to freely vote 5% (less one share) of the outstanding common stock of New PREMERA.[65] The Amended Form A provides for one 5% block to be voted freely, allocated between the two Foundations by their agreement, or allocated totally to the Washington Foundation if the Foundations fail to agree.[66]
- Each Foundation should identify a candidate for election to the Board of Directors of New PREMERA (or, in the alternative, the Washington Foundation should identify such a candidate and the Alaska Foundation should have certain observation rights).[67]
- Each Foundation should be subject to an independent, stand-alone divestiture schedule for the disposition of its New PREMERA common stock.[68]

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[61] *Id.*

[62] Barlow Direct, p. 17.

[63] *Id.*

[64] Barlow Direct, Exhibit B

[65] Exhibit S-4, p. 21.

[66] *See* Amended Form A, Exhibit G-4. It is far from obvious why the OIC Staff's consultants object to this provision, unless they are seeking to protect Alaska's interests.

[67] Exhibit S-4, p. 19.

[68] Exhibit S-4, p. 21.

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On March 18, 2004 Premera presented these concerns to the BCBSA's Plan Performance and Financial Standards Committee ("PPFSC"), the committee of the BCBSA Board that reviews conversion proposals.[69] On March 24, 2004, the PPFSC responded by letter that it could recommend to the BCBSA Board and Member Plans a designated member on the New PREMERA Board of Directors for each Foundation. (That recommendation is subject to BCBSA Board approval.) In the same letter, however, the PPFSC reported that it could not recommend to the BCBSA Board and Member Plans separate 5% free voting blocks or two separate divestiture schedules.[70] Accordingly, insisting on separate 5% free voting blocks or two separate divestiture schedules for the foundations would, if the conversion were consummated on those terms, result in a loss of the Blue marks.

The BCBSA does not dictate whether a plan may or may not convert, and it does not dictate conversion terms to state regulators.[71] It will, however, strip a plan of its Blue license if the plan proceeds with a conversion without a license exception or waiver approved by the BCBSA.[72] The divestiture requirements and voting controls reflected in the Amended Form A are essential aspects of the proposed conversion, not the least because it would be very damaging to Premera's business and to its policyholders to lose the BCBSA license.[73] Premera will pursue conversion only if it can be accomplished consistent with BCBSA license requirements.[74]

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[69] Barlow Direct, p. 19.

[70] Barlow Direct, pp. 17-20 and Exhibits A & B. The BCBSA Board and Member Plans have not yet voted with respect to these issues.

[71] Barlow Direct, p. 17.

[72] *Id.*

[73] Kinkead Resp., pp. 3-4; Koplovitz Deps., 11/20/03, p. 134, and 3/8/04, p. 95; Alderson Smith Dep., 3/9/04, p. 12.

[74] Barlow Direct, p.17.

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It must be remembered that Premera's Amended Form A already reflects many revisions to address concerns expressed by OIC Staff's consultants. The BCBSA restrictions that the OIC Staff's consultants criticize in their supplemental reports are not material to the value of the shares that will be transferred to the Washington Foundation.[75] The investment banking experts testifying on behalf of both parties agree: The negative impact of these relatively minor restrictions, if any, on the value of New PREMERA's shares held by the Foundations would pale in comparison to the impact on that value if Premera were to lose the use of the Blue marks.[76]

Loss of the BCBSA license would also do great harm to the policyholders of Premera. The BCBSA license gives Premera access to a nationwide network of providers that otherwise would be unavailable to Premera subscribers. The licensees of BCBSA are a nationwide network of health plans, all of which must apply strict quality standards, and that makes the Blue mark a premier brand in the industry.[77] The license to use the Blue mark enhances Premera's ability to attract members, contributing to strong financial performance and increased economies of scale.[78] The OIC's primary obligation in reviewing Premera's Amended Form A is to protect the policyholders of Premera and the insurance-buying public. Suggesting changes in Premera's Amended Form A that threaten Premera's use of the BCBSA mark runs directly contrary to that imperative.[79]

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[75] Kinkead Resp., p. 4.

[76] Kinkead Resp., p. 4, *quoting* Alderson Smith Dep., 3/9/04, p. 12.

[77] *See* Amended Form A, Exhibit G-21

[78] McCarthy Direct, pp. 11-12.

[79] The OIC Staff's consultants also raised an issued regarding the requirement in the divestiture schedule that the foundations own less than 80% of the outstanding common stock of New PREMERA by the one-year anniversary of the IPO. This is also a BCBSA requirement and should not be changed. *See* Marquardt Direct.

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D. Duration of the Voting Trust Agreement

Blackstone asserts that the Voting Trust Agreement restrictions are in place solely due to the requirements of the BCBSA.[80] Thus, Blackstone proposes that the Voting Trust Agreement should expire if Premera loses its BCBSA license. Blackstone's rationale is flawed. Even if there were no BCBSA license requirements, the restrictions contained in the Voting Trust Agreement would be reasonable and necessary.[81]

Termination of the Voting Trust Agreement in the event that the BCBSA license is lost would be detrimental to Premera's policyholders and the insurance-buying public.[82] Premera's Board has experience in providing oversight of the management and operations of a health carrier.[83] If the Voting Trust Agreement were to terminate, decisions about Premera could be under the control of the Washington and Alaska Foundations, which have no expertise in such matters.[84] Moreover, the interests of those foundations could be diametrically opposed to the interests of policyholders.[85] The foundations' interest will be to monetize the value of New PREMERA's shares rather than improving products and services for policyholders.[86]

The restrictions in the Voting Trust Agreements are important for the success of New PREMERA's initial public offering and subsequent market stability.[87] Moreover, the investment bankers for both PREMERA and the OIC agree that a mechanism for an orderly sell-down of shares helps support the value of the foundations' holdings.[88]

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[80] Exhibit S-4, p. 16.
[81] Marquardt Direct, p. 29; *see also* Kinkead Resp., p. 11.
[82] *Id.*
[83] *Id.*
[84] *Id.*, p. 30.
[85] Kinkead Resp., pp. 6-7.
[86] Steel Direct, pp. 25-26.
[87] *Id.*, pp. 24-25.
[88] Kinkead Resp., pp. 7-8.

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Agreements like the Voting Trust Agreements are commonplace in similar corporate transactions; they actually may enhance the value of the stock held in trust.[89] Where public investors may be nervous about a large "overhang" of stock (as represented by the Foundations) and potential selling activity on the price of the stock, underwriters often seek to impose restrictions that limit a large shareholder's ability to dominate voting contrary to the interests of public shareholders, and obligate the large shareholder to reduce its holdings of the company's stock according to a visible and predictable schedule.[90] These restrictions, which are present in the Voting Trust Agreements, help reduce public investors' fears of business domination, unexpected selling pressure and price fluctuations caused by a large shareholder. In this way, they generally benefit both the large shareholder and the investing public from a financial perspective.[91]

F. Term of the Washington Economic Assurances

In its Supplemental Report, PwC asserts that Premera's assurances should be extended to three years or longer to provide an "appropriate" level of protection.[92] However, PwC provides no definition of what it means by "appropriate," nor does it give any evidence or support for the proposition that two-year assurances are inappropriate.[93] Premera believes that the two-year term of the Washington Economic Assurances in the Form A Statement is the maximum that can be justified.[94] Premera's belief is supported by BAS, NERA, and Milliman, all of whom explain why a term longer than two years for the Washington Economic Assurances would be unjustified and harmful.[95]

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[89] Steel Direct, p. 24.
[90] *Id.*
[91] *Id.*
[92] Exhibit S-21, pp. 4-5.
[93] *Id.*
[94] Marquardt Direct, pp. 36-37.
[95] *See,* e.g., Kinkead Resp., pp. 6-7; Milliman Supp. Report, p. 2.

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- BAS's Supplemental Report states: "[w]ith respect to these types of assurances, investors will want certainty that those economic assurances do not negatively impact the company from a financial or competitive standpoint."[96] A timeframe longer than two years increases the risk that the assurances would impair Premera's ability to achieve its financial projections or would place the company at a competitive disadvantage.[97]

- NERA concurs that the current timeframe for the assurances is reasonable: "the assurances will likely create operational inflexibilities and potential competitive disadvantages for Premera that can only worsen over time."[98] NERA provides examples how Premera's competitors can leverage the assurances to Premera's detriment.[99]

- Milliman states in its Supplemental Report: "[b]ecause changes in the marketplace are difficult to predict, it would be an unsound business practice for a company such as Premera to make such a rate-related assurance that extends beyond a one to two year period, particularly if competitors are not bound by similar assurances."[100]

Premera's competitors will not be bound by any similar assurances. The longer the term of the assurances, the greater the probability that the assurances will put Premera at a competitive disadvantage.[101]

G. Unallocated Share Escrow Agreement

The Unallocated Shares Escrow Agent Agreement will become effective only if Washington and Alaska are unable to agree upon the allocation of Premera's stock between the two foundations.[102] The two states have been working on this issue for well over a year and have yet to agree on an allocation of the stock. There is no assurance they will do so by the time of the hearing, the Commissioner's decision, or even the closing

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[96] BAS Supp. Report, p. 6.
[97] Kinkead Direct, pp. 6-7.
[98] NERA Supp. Report, p. 1.
[99] *Id.* at p. 4.
[100] Milliman Supp. Report, p. 2.
[101] Marquardt Direct, p. 37.
[102] *See* Amended Form A, Exhibit G-22.

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date of the conversion itself.[103] The Unallocated Shares Escrow Agreement is therefore necessary to address that possibility.[104] For further discussion, *see* Section II.A on p. 55.

H. Definition of "Independence" for New PREMERA's Board

New PREMERA's bylaws define director independence in accordance with a number of factors, including the following: A director is not independent if the director is currently an employee or executive officer of another company that accounts for at least two percent or $1 million, whichever is greater, of New PREMERA's consolidated gross revenues.[105] This definition of "independence" mirrors that found in the similar provision of the New York Stock Exchange ("NYSE") "Listed Company Manual."[106] That manual, and specifically that provision, were recently amended to implement significant changes to the NYSE's listing standards, aimed at ensuring the independence of directors of listed companies and to strengthen corporate governance practices of listed companies.[107] The amendments were approved by the Securities and Exchange Commission ("SEC") in late 2003. In the SEC's view, the amended NYSE rules will foster greater transparency, accountability and objectivity in the oversight by, and decision-making processes of, the boards and key committees of NYSE-listed companies.[108]

Blackstone suggests that the definition of "independence" for New PREMERA's Board needs to be adjusted by lowering the 2% of revenue test.[109] There is no logical

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[103] Marquardt Direct, p. 33.

[104] The C&B Supplemental Report states that Premera's failure to specify an allocation of the shares in New PREMERA between the two foundations is "a fatal defect in the application." Exhibit S-33, p. 77. That statement is directly inconsistent with the facts. The state consultants have insisted that the two states would determine the allocation of New PREMERA shares. Marquardt Direct, p. 34. Premera has been repeatedly told this is to be resolved solely by the states without participation by Premera. *Id.*

[105] *See* Amended Form A, Exhibit B-2.

[106] Marquardt Direct, p. 32.

[107] *Id.*

[108] *Id.*, p. 33.

[109] Exhibit S-4, p. 10.

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support for this position. Requiring New PREMERA to have a definition of an independent director that is more restrictive than the NYSE rules, especially given the approval of those rules by the SEC, is inappropriate. Doing so would narrow the pool of qualified potential directors with knowledge about healthcare issues who are eligible to serve as independent directors of New PREMERA (including, specifically, physicians).[110]

I. Issues Related to Investment Committee

C&B suggests that the functions delegated to the Investment and Program Committees under the foundations' bylaws raises "several serious concerns."[111] These provisions are entirely appropriate for the foundations.[112] Their directors will be required to deal with a number of complex financial strategy, investment banking and securities law issues, as well as issues concerning analysis and monitoring of charitable activities grants.[113] The Investment and Program Committees have very different functions: the Investment Committee is charged with managing and disposing of investments, while the Program Committee is tasked with analyzing and making recommendations with respect to charitable grants, programs and other expenditures.[114] The proper operation of each of these committees requires a different set of skills from their respective members. Good corporate governance dictates that the individuals most qualified for a function should be designated to perform that function. The design of the Investment and Program Committees should not be changed for this reason.[115] Likewise, the required

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[110] Marquardt Direct, p. 33; *see also* Steel Direct, p. 30.
[111] Exhibit S-33, p. 32.
[112] Steel Direct, p. 31.
[113] *Id.*
[114] *Id.*
[115] *Id.*

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qualifications of individuals who are to serve on those committees should not be changed.[116]

C&B also expresses concern that the Investment Committee is delegated the power to determine the control and disposition of the Washington Foundation's holdings of shares of New PREMERA stock.[117] C&B would place that authority in the full board of directors. Premera disagrees with C&B proposal for two reasons. First, the Investment Committee will be composed of individuals highly qualified to review and coordinate the Washington Foundation's trading activities, and the delegation reflected in the Washington Foundation's bylaws is consistent with Washington law.[118] Second, the members of the Investment Committee will have the same fiduciary obligations as all directors. Therefore, they will have to listen to input from the other directors and take into account any "balancing" questions in managing the asset diversification process.[119]

C&B asserts that the appointment of the Investment Committee at the time that the initial Board of Directors (the "First Board") is installed raises an issue of independence from Premera.[120] This comment completely misconstrues the facts.[121] The First Board will be appointed solely to incorporate the Washington Foundation and to apply to the IRS for recognition of the organization's tax-exempt status.[122] It will not have any Investment Committee functions, since the Washington Foundation will not hold any New PREMERA stock until after the state approvals have been obtained and the conversion

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[116] This is so despite C&B's criticism that the requirements are overly strict and unnecessary. Exhibit S-33, p. 32.

[117] Exhibit S-33, pp. 14, 32.

[118] Steel Direct, p. 33.

[119] *Id.*

[120] Exhibit S-33, p. 17.

[121] Marquardt Direct, p. 36.

[122] *Id.*

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and IPO have occurred.[123] Once all state and regulatory approvals of the State of Washington have been obtained and the Second Board has been appointed by the Attorney General of the State of Washington, the First Board will resign and take all actions necessary to effect the installation of the Second Board. The Second Board, upon appointment by the Attorney General, will be in place for a period commencing soon after the approval of the conversion and through the IPO, which avoids any potential independence issue.[124]

The Washington Foundation bylaws provide that the Third Board (as defined in section 3.5.2) will be appointed after New PREMERA's IPO.[125] C&B, in its Supplemental Report, alleges that Premera does not have a "good reason to prevent" appointment before the IPO.[126] On the contrary, there are several good reasons: (1) directors of the Washington Foundation at the time of the IPO will have personal responsibility and liability for the contents of the IPO prospectus as such relates to the Washington Foundation and will be responsible for making decisions about the participation of the Washington Foundation in the IPO (and accordingly, they should have enough knowledge and experience with the Washington Foundation, New PREMERA and the IPO process to be comfortable signing the IPO documents and making the participation decisions); (2) the underwriters will want to finalize disclosure and not deal with last-minute changes in board composition immediately prior to the IPO; and (3) the Attorney General also appoints the Second Board and should have no particular reason to hasten appointment of the Third Board.[127]

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[123] *Id.*

[124] *Id.*

[125] *See* Amended Form A, Exhibit E-2.

[126] Exhibit S-33, p. 31.

[127] Steel Direct, p. 34; see also Marquardt Direct, p. 36.

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J. Restrictions on Use of Proceeds of Sale of New PREMERA Stock

C&B questions why it is necessary to afford New PREMERA enforcement rights with respect to the restrictions on "purposes" to which the foundations may devote the proceeds of New PREMERA stock.[128] Premera has a significant business interest in ensuring that the foundations follow their charitable purposes.[129] Further, the transfer of New PREMERA stock is a voluntary act. The Premera Articles of Incorporation state that on dissolution the proceeds (i.e., the New PREMERA stock) shall be distributed to one or more non-profit entities to be used exclusively for purposes consistent with Premera's purposes. The Premera Board has concluded that the purposes of the Foundations, as contained in their Articles of Incorporation and as set forth in the Transfer, Grant and Loan Agreement are so consistent.[130] Premera has sensibly designated New PREMERA as the continuing corporate entity that has the power to enforce these intended restrictions on use of the proceeds for the designated health care purposes.[131]

K. Change in Control Threshold in the Voting Trust Agreement

Blackstone's supplemental report suggests that the shareholder ownership percentage threshold in the Change in Control provision of the Voting Trust Agreement should drop from 50.1% to 20.1%.[132] This is contrary to WellChoice and not appropriate.[133]

The OIC Staff's consultants have consistently used the WellChoice transaction as their model of transaction structure "best practice."[134] Premera's proposal is precisely the

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[128] Exhibit S-33, pp. 33-36, 85-86; see also Amended Form A, Exhibits E-1, E-2 and G-19.

[129] Steel Direct, p. 33.

[130] *See* Amended Form A, Exhibits E-1 and G-3.

[131] *Id.*

[132] Exhibit S-4, p. 17.

[133] Marquardt Direct, p. 25; *see also* Kinkead Direct, pp. 8-9.

[134] *Id.*

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same as the WellChoice transaction term on this point. The BCBSA, which approved the 50.1% threshold in the WellChoice transaction, has advised Premera that it would not approve a reduction in the threshold.[135] Maintaining compliance with the BCBSA requirements is essential to the company and its members and is a prerequisite for this transaction.[136] For this reason, Premera cannot accede to Blackstone's recommendation.[137]

L. Selection of Board Nominees Submitted by the Washington Foundation

Blackstone opines that New PREMERA should be required to choose one of the three board nominees submitted by the Washington Foundation and should not have a right to veto nominees.[138] The proposal to have a "Designated Member" on the New PREMERA Board of Directors was accepted by Premera as an accommodation to a request by the consultants, subject to Premera's right to require additional nominees if the initial candidate(s) were not accepted by the New PREMERA Board.[139] The OIC Staff's consultants did not object to that proviso at any time during the course of discussions prior to the filing of the Form A amendments on February 5, 2004.[140] Moreover, Premera's mechanism for selecting a "Designated Member" is more generous than that used in the WellChoice transaction. Premera must consult with the foundations regarding the factors involved in rejecting a particular nominee, if so requested by the foundations.[141] The WellChoice transaction does not have this consultation right. The provision should thus stand as drafted.

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[135] *Id.*

[136] Barlow Direct, p. 17.

[137] *Id.*

[138] Exhibit S-4, p. 19.

[139] *Id.*

[140] *Id.*

[141] *See* Amended Form A, Exhibit G-4, Section 5.03.

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Blackstone also opines that the Washington Foundation's right to designate a board member should not terminate after five years.[142] In WellChoice, the provision for a designated board member expires five years after the IPO or when the foundation owns less than 5% of the outstanding stock, whichever occurs earlier.[143] Premera's proposal tracks WellChoice. The BCBSA has advised that a deviation from the WellChoice provision on the term of the designated board member would not be approved.[144]

M. Window to Complete IPO After Receiving Regulatory Approvals

Blackstone states that the window to complete an IPO after receiving all regulatory approvals should be 12 months and that the automatic three-month extensions should be removed.[145] Blackstone reasons that "[t]welve months represents an adequate window for Premera to complete an IPO based on a consideration of prior conversions and the potential for equity market dislocations."[146] Premera agrees that 12 months is adequate to address equity market dislocations.[147] But that is not the reason for having two automatic three-month extensions.[148] Section 4.3(b)(i) of the Plan of Conversion provides, in part, as follows: "Notwithstanding the foregoing, in the event there is any pending litigation related to the Conversion on the Closing Date, the 12-month period set forth above shall be extended by up to two successive three (3) month periods and, in addition, any approval period may be extended at the discretion of the Washington Insurance Commissioner . . . ." (Emphasis added.)[149]

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[142] *Id.*
[143] *Id.*
[144] *Id.*
[145] *Id.* at p. 7.
[146] *Id.*
[147] Marquardt Direct, p. 22.
[148] *Id.*
[149] *Id.*

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Pending litigation related to the Conversion, if it occurs, could extend past the 12-month window.[150] If no such litigation occurs, or if it is disposed of within 12 months of receiving the approvals, then the automatic extensions cannot be invoked, and the only extension possible is at the discretion of the Commissioner.[151] The inclusion of three-month automatic extensions for pending litigation, among other things, avoids creating a perverse incentive for those wishing to challenge the conversion to drag out the resolution of their claims.[152]

N. The Prohibition of Lobbying Against the Interests of Health Insurers Is Appropriate.

C&B asserts that the provisions in the foundations' Articles of Incorporation and bylaws prohibiting the foundations from lobbying for or against activities that would be materially adverse to health insurers allows Premera to exert too much influence upon the foundations.[153] Premera disagrees. It is entirely proper for Premera to carve out activities potentially harmful to it, and to prohibit the charitable recipient of New PREMERA stock from engaging in those activities.[154] Within the permissible scope of their charitable activities, this does not affect the foundations' independence at all.[155]

O. The Amendment Provisions in the Foundation's Articles Are Reasonable.

The Washington Foundation's Articles of Incorporation and bylaws can be amended only by a three-quarters vote of the directors then in office and advance written approval of the Attorney General.[156] C&B claims that this amendment mechanism

[150] *Id.*
[151] *Id.* at p. 23.
[152] *Id.*
[153] Exhibit S-33, p. 26.
[154] Reid Supp. Report, p. 16.
[155] *Id.*
[156] *See* Amended Form A, Exhibits E-1 and E-2.

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reduces the flexibility that the board of the Washington Foundation will have to modify these charter documents to meet the foundation's needs.[157] This is not an unusual provision, and it is actually more flexible than an earlier draft of the same provisions prepared by C&B.[158] The California Endowment has a similar restriction that prohibits amendments of key provisions of its articles and bylaws without consent of the Attorney General.[159] Mr. Reid testified that he, as the former President and CEO of The California Endowment, would have been reluctant to seek the Attorney General's approval for a request not backed by virtually unanimous support of the board of directors.[160] The supermajority requirement should thus not be an impediment to legitimate proposed amendments to the governing documents (e.g., an amendment required by the IRS for the foundations to be recognized as tax-exempt under Code Section 501(a)).[161]

P. The Guaranty Agreements

C&B raises an issue with respect to one proposed agreement, the New PREMERA Guaranty issued to New Premera Blue Cross ("New PBC").[162] C&B asks why the New PBC guarantee is not identical to the guarantee given to New Premera Blue Cross-Alaska ("New PBC-AK"). The answer is that New PBC is a "Larger Controlled Affiliate," as defined under the BCBSA License because it has more than 15% of Premera's members. New PBC-AK is not, and the BCBSA Controlled Affiliate License Agreement directs that different standards of financial responsibility are applicable to each.[163] The OIC Staff's

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[157] Exhibit S-33, p. 30.

[158] *See* Cantilo Dep., 3/22/04, pp. 337-44.

[159] Reid Direct, p. 15.

[160] *Id.*

[161] *Id.*

[162] Exhibit S-33, p.21; *see also* Amended Form A, Exhibit G-8.

[163] *See* Amended Form A, Exhibit G-20, Part C.

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consultants asked Premera to use the BCBSA license standards in the Guaranty Agreements.

Q. Other Transaction Issues

In addition to the items discussed above, there are a number of issues in the Amended Form A that appear to have been resolved or clarified since the parties filed their supplemental reports. In a few instances, the OIC Staff's consultants claimed that a particular right, such as the foundations' ability to participate in pricing decisions for equity offerings, do not exist in the transaction documents. This assertion, as well as others, is not accurate.[164] In addition, Premera submitted an errata sheet which addressed a number of technical corrections to the transaction documents.[165] The OIC Staff's consultants appear to be comfortable with these corrections.[166]

CONCLUSION

Premera's Conversion presents a unique opportunity to strengthen Premera, to benefit its subscribers and the insurance-buying public, and to create a major new foundation that will help address the unmet health needs of Washington residents. Premera's Form A meets all applicable legal requirements and should be approved.

DATED this 23rd day of April, 2004.

Respectfully submitted,

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[164] Marquardt Direct 21-37

[165] Marquardt Direct, Exhibit A

[166] Cantilo Resp.

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APPENDIX A

THE FACTORS ENUMERATED UNDER SUBSECTION 5(a)(ii)(C) OF THE HCA DO NOT COME INTO PLAY UNLESS THERE IS AN ANTICOMPETITIVE EFFECT

Even though there is no basis for finding that Premera's Form A violates the standards set forth in RCW 48.31C.030(5)(a)(i) or (a)(ii), the OIC Staff's consultants contend that the Commissioner can still disapprove the conversion under the factors listed in subsection 5(a)(ii)(C). They argue that these factors are independent of subsection 5(a)(ii), even though they are a part of subsection 5(a)(ii). Because this contention ignores the plain language of the statute and well-established principles of statutory interpretation, it must be rejected.

A. Comparison of HCA and IHCA Demonstrates that the Factors Listed in HCA's Subsection 5(a)(ii)(C) Are Part of the Commissioner's Antitrust Determination.

The Washington Legislature drafted the HCA differently from the IHCA. These differences demonstrate the Legislature's intent to integrate the factors listed in subsection 5(a)(ii)(C) of the HCA into the Commissioner's antitrust determination.

In 1993 the Legislature directed the Commissioner, in making an antitrust determination under subsection 4(a)(ii) of the IHCA, to follow three guidelines:

> In applying the competitive standard in (a)(ii) of this subsection:
>
> (A) The informational requirements of RCW 48.31B.020(3)(a) and the standards of RCW 48.31B.020(4)(b) apply;
>
> (B) The commissioner may not disapprove the merger or other acquisition if the commissioner finds that any of the situations meeting the criteria provided by RCW 48.31B.020(4)(c) exist[1]; and

[1] RCW 48.31B.020(4)(c) provides for approval of an otherwise anticompetitive acquisition if the public benefits from the acquisition outweigh the anticompetitive effects. It states:

> An order may not be entered under subsection (5)(a) of this section if:
>
> (i) The acquisition will yield substantial economies of scale or economies in resource use that cannot be feasibly achieved in any other way, and the public benefits

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> (C) The commissioner may condition the approval of the merger or other acquisition on the removal of the basis of disapproval within a specified period of time;

RCW 48.31B.015(4)(a)(ii).

In short, these three guidelines under the IHCA state that the Commissioner's antitrust determination will be guided by (1) informational requirements, (2) mandatory approval for otherwise anticompetitive acquisitions that result in substantial public benefits, and (3) conditional approval for acquisitions that are anticompetitive but can be structured to be competitive or to provide substantial public benefits to justify the anticompetitive effects. The Legislature then added subsections 4(a)(iii) - (vi) as stand-alone bases for rejecting an acquisition under the IHCA, wholly apart from the antitrust standard in subsection 4(a)(ii):

> The commissioner shall approve a merger or other acquisition of control referred to in subsection (1) of this section unless, after a public hearing thereon, he or she finds that:
>
> ***
>
> (iii) The financial condition of an acquiring party is such as might jeopardize the financial stability of the insurer, or prejudice the interest of its policyholders;
>
> (iv) The plans or proposals that the acquiring party has to liquidate the insurer, sell its assets, consolidate or merge it with any person, or to make any other material change in its business or corporate structure or management, are unfair and unreasonable to policyholders of the insurer and not in the public interest;
>
> (v) The competence, experience, and integrity of those persons who would control the operation of the insurer are such that it would not be in the interest of policyholders of the insurer and of the public to permit the merger or other acquisition of control; or

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that would arise from the economies exceed the public benefits that would arise from not lessening competition; or

(ii) The acquisition will substantially increase the availability of insurance, and the public benefits of the increase exceed the public benefits that would arise from not lessening competition.

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(vi) The acquisition is likely to be hazardous or prejudicial to the insurance-buying public.

RCW 48.31B.015(4)(a)(iii) - (vi).

In marked contrast to the IHCA, the Washington Legislature in 2001 rejected the use of such factors as stand-alone grounds for disapproval under the HCA by making them a subpart of the Commissioner's antitrust determination. The Legislature drafted the HCA's antitrust determination section to encompass the same three guidelines as in the IHCA. The Legislature, however, completely altered the third guideline, dealing with conditional approval of anticompetitive acquisitions: It listed under that guideline the four criteria that, in the IHCA, constitute independent grounds for evaluating a Form A. The HCA provides as follows:

As to the commissioner, in making this determination:

***

(C) The commissioner may condition the approval of the acquisition on the removal of the basis of disapproval, **as follows**, within a specified period of time:

(I) The financial condition of an acquiring party is such as might jeopardize the financial stability of the health carrier, or prejudice the interest of its subscribers;

(II) The plans or proposals that the acquiring party has to liquidate the health carrier, sell its assets, consolidate or merge it with any person, or to make any other material change in its business or corporate structure or management, are unfair and unreasonable to subscribers of the health carrier and not in the public interest;

(III) The competence, experience, and integrity of those persons who would control the operation of the health carrier are such that it would not be in the interest of subscribers of the health carrier and of the public to permit the merger or other acquisition of control; or

(IV) The acquisition is likely to be hazardous or prejudicial to the insurance-buying public.

RCW 48.31C.030(5)(a)(ii) (emphasis added).

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The Legislature's deliberate insertion of the words "as follows" signals the Legislature's intent to specify these factors as bases for conditional approval of an otherwise anticompetitive acquisition. In placing these factors as a subset of the antitrust provision, the Legislature rejected their use as stand-alone grounds for disapproval, as in the IHCA, and made them part of the Commissioner's antitrust determination under the HCA.

Well-settled principles of statutory interpretation dictate that the factors listed in HCA's subsection 5(a)(ii)(C) must be interpreted in light of the larger antitrust subsection in which they are found. *See In re Detention of Williams,* 147 Wn.2d 476, 490, 55 P.3d 597 (2002) ("[i]n order to interpret a statute, each of its provisions 'should be read in relation to the other provisions, and the statute should be construed as a whole.'") (quoted source omitted); *State v. Parker,* 97 Wn.2d 737, 741, 649 P.2d 637 (1982) ("[w]hen construing a statute, … we must read it in its entirety and not piecemeal."). In addition, the Legislature is presumed to have acted intentionally in drafting the statute. *See State v. McKinley,* 84 Wash. App. 677, 686, 929 P.2d 1145 (1997) ("[b]ecause the Legislature is presumed not to pass meaningless legislation, when it enacts an amendment to a statute, a presumption exists that a change was intended."). *See also State v. Moses,* 145 Wn.2d 370, 374, 37 P.3d 1216, 1218 (2002) ("Where the Legislature omits language from a statute, intentionally or inadvertently, this court will not read into the statute the language that it believes was omitted.").

B C&B's Analysis of the HCA Is Erroneous.

Ignoring both the plain language of the statute and principles of statutory interpretation, C&B argues that the four factors set forth under subsection 5(a)(ii)(C) are independent tests, separate from the Commissioner's antitrust determination under subsection 5(a)(ii). C&B asserts that these factors were meant to mirror similar factors in

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the IHCA, and that the Legislature essentially made a formatting error in not setting the factors out separately from the larger subsection. C&B states:

> It appears that in 2001, when the [Holding Company Act] was enacted, it was modeled after the pre-existing [Insurer Holding Company Act] but, in the process, what would have become paragraphs (iii) through (vi) of RCW 48.31C.030(5)(a) mistakenly became paragraphs (I) through (IV) of RCW 48.31C.030(5)(a)(ii)(C). *Compare* RCW 48.31C.030(5)(a) *with* 48.31B.015(4)(a). This apparent legislative error should not substantively affect the Commissioner's analysis of the Transaction.

Ex. S-31, p. 27 n.57. C&B cites no legislative history or any other authority to support its claim, which rests entirely upon superficial comparison of the two Acts and C&B's assumption that this key difference between them is "legislative error."[2]

In Washington, perceived legislative error may be corrected only in the rare instance that an omission or mistake makes the statute entirely meaningless. The Washington Supreme Court "'has exhibited a long history of restraint in compensating for legislative omissions.'" *State v. Delgado*, 148 Wn.2d 723, 730-31, 63 P.3d 792 (2003), quoting *State v. Taylor*, 97 Wn.2d 724, 728, 649 P.2d 632 (1982).

> We have noted three broad types of cases in which we find legislative errors. … In the first type, a statute contains an omission or mistake, but the court is able to guess why the legislature intended a literal reading of the statute. The court does not correct this type of perceived legislative error. …
>
> In the second type, we will not correct perceived errors if an omission or mistake creates some inconsistencies, but the statute remains rational on

[2] There are several other differences between the IHCA and the HCA. For example, while both Acts require persons acquiring control of a domestic insurer/health carrier to obtain Commissioner approval, the IHCA additionally prevents any person other than the issuer from acquiring control through the acquisition of voting securities. *Compare* RCW 48.31C.030(1) *with* RCW 48.31B.015(1). Both Acts contain provisions authorizing the Commissioner to determine the anticompetitive impact of the acquisition, but only the IHCA requires the Commissioner to consider a statutory market concentration standard in its determination. *Compare* RCW 48.31C.030(5)(a)(ii)(A) *with* RCW 48.31B.015(4)(a)(ii)(A). The HCA also directs the Commissioner to perform the antitrust analysis only if "the office of the attorney general and any federal antitrust enforcement agency has chosen not to undertake a review of the proposed acquisition"; the IHCA, in contrast, has no such limitation on the Commissioner's power. *Compare* RCW 48.31C.030(5)(a)(ii) *with* RCW 48.31B.015(4)(a)(ii).

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> the whole. … We will not "arrogate to ourselves the power to make legislative schemes more perfect, more comprehensive and more consistent." ...
>
> * * *
>
> The third type of legislative omission, an omission making a statute entirely meaningless, is the only type we will correct. For example, an omission creating a statute that simultaneously qualifies a person for commitment and release is meaningless. … In such a case, the statute is not functional without judicial correction because it is completely ineffective in achieving its purpose.

State v. Delgado, 148 Wn.2d at 730-31 (emphasis added) (quotations and citations omitted).

There can be no credible argument that applying the tests in the HCA as the Legislature directed would render the statute "entirely meaningless." Subsection 5(a)(ii) provides one basis for Commissioner disapproval: substantial evidence of anticompetitive effect in the health insurance market. The beginning of the subsection states explicitly, "The commissioner shall approve an acquisition of control … unless … he or she finds that … there is substantial evidence that the effect of the acquisition may substantially lessen competition or tend to create a monopoly in the health coverage business." RCW 48.41C.030(5)(a)(ii). All the subparts that follow are an elaboration of this basic statement. The subsection provides that "in making this determination … [t]he commissioner may not disapprove the acquisition if the commissioner finds that" the acquisition creates certain benefits which outweigh the benefits from increased competition. RCW 48.41C.030(5)(a)(ii)(B). The HCA identifies these compensating benefits as "substantial economies of scale or economies in resource use that cannot be feasibly achieved in any other way" and the substantial increase or prevention of "significant deterioration in the availability of health care coverage." RCW 48.31C.030(5)(a)(ii)(B). Thus, read as a whole, subsection 5(a)(ii) allows the Commissioner to disapprove the conversion only if it creates anticompetitive effects

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without any compensating economies of scale or increase in terms of availability of health care coverage.

Read in this proper context, subpart C allows the Commissioner to remedy the basis for disapproval, namely the lack of any compensating economies of scale or increase in availability of health care coverage. The factors enumerated in subpart C are factors that underlie a failure to produce these two compensating benefits. Poor financial condition of the resulting entity, "unfair and unreasonable" changes to the business, unqualified directors and officers, and acquisition features that are "hazardous or prejudicial to the insurance-buying public" are all factors that undercut an acquisition's capacity for creating economies of scale or an increase in the availability of health care coverage in the State. When read in its proper place as a subpart of subsection 5(a)(ii), these factors allow the Commissioner to condition his approval of an anticompetitive acquisition upon the removal of factors that prevent the realization of the compensating benefits identified in subpart B. If, by contrast, there is no finding of anticompetitive effect, section 5(a)(ii) mandates that "[t]he commissioner shall approve" the acquisition, and the factors enumerated in subpart C simply do not apply.

The Legislature's insertion of the language "as follows" section 5(a)(ii)(C) undercuts any suggestion that the structure of the HCA was simply a formatting error, as C&B seems to imply. Under C&B's rationale, the Commissioner would be justified in glossing over any differences between similar provisions in the two Acts. As explained above, such a rule is at odds with well-settled principles of statutory construction. *See City of Kent v. Beigh*, 145 Wn.2d 33, 45, 32 P.3d 258, 264 (2001) ("[I]t is an 'elementary rule that where the Legislature uses certain statutory language in one instance, and different language in another, there is a difference in legislative intent.'") (quoted source omitted). It would therefore be error to conclude, as C&B does, that these differences in otherwise similar provisions in the HCA and the IHCA are "apparent legislative error."

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See Delgado, 148 Wn.2d at 730-31. Because the HCA lists the factors in subsection 5(a)(ii)(C) as part of the Commissioner's antitrust determination, the Commissioner must interpret these factors within their proper antitrust context. And because the conversion will not change market shares or otherwise have an anticompetitive effect, the Commissioner may not evaluate the conversion under these factors.

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APPENDIX B

APPLICATION OF ANTITRUST LAW AND ECONOMIC PRINCIPLES DEMONSTRATES COMPETITION IN THE RELEVANT MARKETS

A. The Market for Health Insurance is Competitive.

Premera's premiums are at competitive levels because it lacks market power in the state-wide market for insurance products. Premera's economic expert, Dr. Thomas McCarthy of National Economic Research Associates, Inc., explains in his report that Premera's lack of market power is demonstrated by the fact that Premera has only 28.4% of the state-wide market for insurance products, faces a number of strong competitors, is not protected by substantial barriers to entry or expansion, and does not have supracompetitive premiums or profit margins. *See* Report of National Economic Research Associates, Inc., "Antitrust and Economic Impact Analysis of the Proposed Conversion of Premera Blue Cross in the State of Washington," November 10, 2003 ("NERA Report"), p. ES-3. As both Dr. McCarthy and the OIC's economist, Dr. Keith Leffler agree, "under basic economic principles, Premera could increase its prices or reduce its provider reimbursements *only if it possesses market power* as a seller of insurance or as a buyer of provider services." Ex. S-16, Report of Keith Leffler, Ph.D "Antitrust Review by the Office of the Insurance Commissioner" ("Leffler Report"), p. 7 (emphasis added). Dr. McCarthy concludes that, because Premera lacks market power, there is no basis for arguing that the conversion will result in supracompetitive premiums.

1. The OIC's Economist Agrees that Competition and Regulation Constrain Premera from Raising Premium Rates Throughout Washington.

As a threshold matter, Dr. Leffler acknowledges that, even if Premera has market power (which it does not), the conversion will not change the fact that Premera cannot raise its premiums in the current regulatory and competitive environment. Dr. Leffler agrees that Premera's rates for individual and small group policies are subject to both

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competition and regulatory constraints. He states that Premera faces vigorous competition in Western Washington and, because of OIC regulations requiring state-wide community rating, competitive conditions in the I-5 corridor result in competitive rates in Eastern Washington as well. *See* Leffler Report, p. 3. That same state-wide rating practice by Premera also constrains its large group rates throughout the state. Moreover, the size and negotiating strength of larger groups is sufficient to offset any market power that Premera might try to exercise in the large group line of business. *See* Leffler Report, p. 4. Dr. Leffler ultimately concludes that competition and regulatory restrictions currently prevent Premera from raising premiums above a competitive level, and that the conversion would do nothing to change this scenario:

> Thus, I did not find any evidence that Premera is taking substantial advantage of any market power it may have in setting premiums at this time ... [I]f Premera continues to compete statewide and if the OIC assures that variance in individual and small group premiums result only from regional cost differences, then there is little reason to expect any change in the pricing of these policies.

Leffler Report, p. 4.

2. The OIC's Economic Impact Consultants Fail to Demonstrate That Premera Has Market Power.

PricewaterhouseCoopers ("PwC") contends that the conversion will enable New PREMERA to raise premiums in Eastern Washington. *See* Ex. S-20, PwC Economic Impact Report, pp. ES-8 and 95, Table 9-2. PwC's contention purportedly rests entirely on Dr. Leffler's analysis of market power, but it totally ignores Dr. Leffler's ultimate conclusion that such market power is constrained by competition and regulation. *See, e.g.*, Deposition of Edward A. Gold, 11/26/03, pp. 195-99.

In reality, as Dr. McCarthy of NERA concluded, Premera does not have market power. It then follows as a matter of economic principle that New PREMERA will not have the ability to charge supracompetitive premiums after conversion. Dr. Leffler's

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contrary opinion on Premera's market power is unsupportable, because in significant part, it rests on a fatally flawed market definition.

(a) Dr. Leffler's Market Power Analysis Rests on a Flawed Definition of the Relevant Market.

In defining a relevant market, antitrust courts use both demand and supply substitution principles. *Rebel Oil v. Atlantic Richfield Co.,* 51 F.3d 1421, 1436 (9th Cir.), *cert. denied*, 516 U.S. 987 (1995); *Blue Cross & Blue Shield United of Wisconsin v. Marshfield Clinic*, 65 F.3d 1406, 1410 (7th Cir. 1995) ("in defining a market, one must consider substitution both by buyers and sellers"); *Brown Shoe Co. v. United States*, 370 U.S. 294, 325 n.42 (1962). Demand substitution means that the market should include all insurance products that Premera subscribers can reasonably turn to if their premiums were to rise beyond a competitive level. *See, e.g., Brown Shoe,* 370 U.S. at 325. Supply substitution means that the market should include those insurers who can reasonably start offering or expand their offering of products to compete with Premera's products. *Ad/SAT v. Associated Press*, 181 F.3d 216, 227 (2d Cir. 1999). In other words, supply substitution is defined as

> the extent to which producers of one product would be willing to shift their resources in response to an increase in the price of the other product . . . . Where there is cross-elasticity of supply, a would-be monopolist's attempt to charge supracompetitive prices will be thwarted by the existence of firms willing to shift resources to producing the product, thereby increasing supply and driving prices back to competitive levels.

Id.

Dr. Leffler fails to adequately take into account supply substitution in his market definition. *See* Leffler Report, pp. 18-20; Pre-Filed Responsive Testimony of Keith Leffler, Ph.D ("Leffler Resp."), p. 3. His market definition excludes insurers that can expand into Premera's product lines in response to supracompetitive pricing. It also does not reflect the fact that insurers in one area of the state can easily offer insurance in another part of the state. Leffler Report, pp. 18-20. In short, by excluding these market

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realities, Dr. Leffler artificially segments the state-wide market for all insurance products into numerous localized "markets" for each type of health insurance. The result of this exercise is an appearance of high market shares in some products in some localized markets. Thus, premised on an erroneous market definition, he infers market power. This is the basis for PwC's claim that Premera has the ability to raise premiums in "markets" defined as certain counties in Eastern Washington.

Courts have consistently held that it is improper to disregard supply substitution in defining a relevant market. *See Rebel Oil,* 51 F.3d at 1436; *AD/SAT v. Associated Press,* 181 F.3d at 227 ("[a]lso relevant to the delineation of a relevant product market is cross-elasticity of supply…"); *In re Municipal Bond Reporting Antitrust Litigation,* 672 F.2d 436, 441 (5th Cir. 1982) ("[t]he limitation of the parameters of the relevant market as suggested by Munitrad fails to give due accord to the significance of elasticity of supply and demand in antitrust evaluations."). Indeed, in *Rebel Oil,* the Ninth Circuit rejected Dr. Leffler's market power analysis in that case because of his failure to account for supply substitution. The court stated that "defining a market on the basis of demand considerations alone is erroneous …. A reasonable market definition must also be based on 'supply elasticity.'" 51 F.3d at 1436. The Commissioner should adopt the sound reasoning of *Rebel Oil,* and reject Dr. Leffler's analysis.[1]

Although Dr. Leffler pays lip service to supply substitution (*see* Leffler Resp., p. 3), he does not offer his own independent analysis of supply substitution factors. Instead,

[1] In defining the relevant market, Dr. Leffler purports to rely on the United States Department of Justice Federal Trade Commission Horizontal Merger Guidelines ("Merger Guidelines"). However, Dr. Leffler ignores the Guidelines' recognition of supply substitution in defining the relevant market (called "uncommitted entr[y]"). The Merger Guidelines take into account the likely supply response by competitors to a firm's price increase. Merger Guidelines, ¶ 1.0.

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he takes "pot-shots" at Dr. McCarthy's analysis of how supply substitution factors are a necessary part of market definition.

(b) Dr. Leffler's Critique of NERA's Supply Substitution Analysis Is Unsupportable.

Dr. Leffler's critique of Dr. McCarthy's supply substitution analysis is wrong because (1) it fails to adhere to established antitrust law, and (2) it ignores evidence of actual and potential entry and expansion.

As shown above, principles of supply substitution must be considered in defining a relevant product market. Moreover, even if there are high barriers to entry and expansion, the potential supply response by competitors must be addressed in connection with market definition. *Ryko Manufacturing Co. v. Eden Serve*, 823 F.2d 1215 (8th Cir. 1987) *cert. denied*, 484 U.S. 1026 (1988); *Rebel Oil*, 51 F.3d at 1439. Even assuming the existence of entry barriers and a dominant market share, as Dr. Leffler does, market power still cannot be inferred in the presence of existing firms that can shift or increase their output in response to a price increase or a contraction in supply. *Rebel Oil*, 51 F. 3d at 1441. Accordingly, Dr. Leffler's claim that supply substitution is irrelevant here is contrary to existing law.

Further, Dr. Leffler's discrete criticisms of examples of entry and expansion selected from Dr. McCarthy's analysis do not withstand scrutiny. The soundness of Dr. McCarthy's evidence of entry and expansion and the corresponding emptiness of Dr. Leffler's dismissal of that evidence are made clear by the following.

First, Dr. McCarthy identified the entry of Asuris (a Regence company) into 14 counties in Eastern Washington as evidence of low barriers. Within four years, Asuris gained over 23,000 members in its small group product. (Further, in late 2003, Asuris expanded its product line when it began offering individual policies). NERA Report, p. 17. Dr. Leffler characterizes this example of entry and expansion as "far from

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compelling." Leffler Resp., p. 12. However, the appropriate measure of successful entry, such as that of Asuris, is the performance of the market. Dr. Leffler points to no evidence that premiums or profit margins anywhere in Washington, including the 14 Eastern Washington counties, are at supracompetitive levels. Thus, one can only conclude that entry has been sufficient.

Second, Dr. McCarthy cited NYLCare's 1998 expansion into Eastern Washington and purchase by Aetna as another example of actual entry into Eastern Washington. NERA Report, p. 17, Table 3. Dr. Leffler trivializes this entry, claiming that Aetna only had 23 members in Eastern Washington as of the end of 2002. Leffler Resp., p. 11. This is misleading. July 2003 data reflects that Aetna had enrollment of as least 12,435 and 13,615 PPO members in the 14-county and 20-county areas in Eastern Washington, respectively. HealthLeaders Research, *Washington Health Plan Data, PPO Enrollment*, July 2003. Moreover, since entering the market, Aetna has developed its own provider network in Eastern Washington, demonstrating a commitment to growth in that region. Antitrust law acknowledges such examples as valid entries into the market. *See Omega Environmental, Inc. v. Gilbarco, Inc.*, 127 F.3d 1157, 1164 (9th Cir. 1997) (acknowledging the acquisition and expansion of a competitor as demonstration of low entries to barrier in market), *cert. denied* 525 U.S. 812 (1998).

As a third example, Dr. McCarthy pointed to Northwest One's expansion from Western into Eastern Washington as evidence of low barriers. Dr. Leffler brushes aside this evidence, claiming that Northwest One provides no health insurance. His claim ignores the fact that Northwest One does have some self-insured business. More importantly, as a rental network, it directly affects competition by establishing an alternative provider network to third party administrators (TPAs) and companies that offer fully insured products, e.g., CIGNA, thus providing the operational elements necessary to

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compete and reducing the costs to new entrants. These are just some examples of competition that demonstrate the absence of any significant barriers to entry or expansion.

Dr. Leffler's attempts to define the market narrowly fall short. His analysis ignores firmly rooted principles of antitrust law, and on that basis alone should be discounted. In addition, his efforts to skirt the supply substitution issue altogether by challenging Dr. McCarthy's entry and expansion analysis fail. The market should properly be defined, taking into account not only consumer demand, but also the likely supply response by competitors that results in a state-wide market for health insurance products.

3. The OIC's Economic Impact Consultants Cannot Establish That Premera Can Charge Supracompetitive Premiums.

As established above, PwC's reliance on Dr. Leffler's erroneous assertions of market power is entirely misplaced. Without evidence of market power, their bald assertion about *possible* increases of premiums does not even begin to materialize. More importantly, even assuming that Dr. Leffler's market power analysis is correct (which it is not), PwC entirely ignores the economic realities of the marketplace, as well as the ultimate conclusion reached by both Dr. Leffler and Dr. McCarthy: competition and regulation combine to restrain any market power that Premera could even possibly possess. Premiums charged by Premera are priced competitively, and nothing about the conversion will change this.

B. <u>The Market for Provider Services is Competitive.</u>

Premera's reimbursement rates to providers in Washington are competitive. Premera does not possess market power; thus, it cannot pay providers below competitive levels. Nothing about the conversion will change this. NERA Report, pp. ES-7-9.

Dr. Leffler again argues that Premera has market power in Eastern Washington. In order to arrive at this conclusion, he inflates Premera's market share for the purchase of

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provider services by excluding patients who are covered by self-insurance and government sponsored programs (i.e., Basic Health Plan, CHIP, Healthy Options, and Medicare). By excluding these patients, Dr. Leffler incorrectly transforms Premera's 25% market share into 70% to 80%. Leffler Resp., p. 13.

Dr. Leffler explains that the relevant market encompasses just the "more valuable 'private' insured patients." Leffler Resp., p. 13. However, the price differential between these patient types is not a sufficient reason to exclude the lower priced patients from the relevant market. *See Twin City Sportservice, Inc. v. Charles O. Finley & Co., Inc.*, 512 F.2d 1264, 1274 (9th Cir. 1975) ("the scope of the relevant market is not governed by the presence of a price differential between competing products."); *Murray Publishing Co., Inc. v. Malmquist*, 66 Wn. App. 318, 327, 832 P.2d 493 (1992) ("[t]he mere fact that competing advertising media may be more expensive does not govern the scope of the relevant market."). *Cf. Omega Environmental, Inc. v. Gilbarco, Inc.*, 127 F.3d 1157, 1163 (9th Cir. 1997) (holding that a company's inability to sell its products to financially sophisticated distributors does not constitute foreclosure of the market, because other types of customers were available). Because Dr. Leffler fails to provide a proper market definition, he does not establish that New PREMERA will have the market power to lower provider reimbursements below competitive levels.[2]

[2] Dr. Leffler also asserts that NERA's statement that Premera's lower reimbursement rates in return for directing greater volume to a provider is a tacit acknowldegement of market power. Leffler Resp., p. 14. This is simply a statement taken out of context. The statement is taken from a paragraph in NERA's Report which begins with the following important qualifier: "even if Premera does have lower reimbursement rates than First Choice and Regence in Spokane, this is not necessarily evidence that Premera has market power." NERA Report, p. 58. NERA had already concluded in the previous section that, based upon its analysis of the market structure and competitive effects, Premera does not have market power to impose supracompetitive reimbursement rates in Eastern Washington. In most competitive markets, higher buying volumes yield discounts, which are then passed on to consumers. Anyone who shops at Costco, Sams' Club, or Trader Joe's has benefited from volume purchases. Paying lower prices for the product that Costco buys is not the type of buyer market power that the antitrust laws condemn.

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APPENDIX C

C&B ISSUES PREMISED ON CHARITABLE TRUST AND/OR FAIR MARKET VALUE ASSUMPTIONS

	ISSUE	C&B SOURCE REFLECTING ATTRIBUTION TO CHARITABLE TRUST AND/OR FAIR MARKET VALUE ASSUMPTIONS		
		C&B Supplemental Report ("**SR**") Executive Summary to SR ("**ES**")	Pre-Filed Direct Testimony of Patrick Cantilo	Pre-Filed Responsive Testimony of Patrick Cantilo
1.	Economic viability of Transaction	SR, pp. 12-13, 81-82.		
2.	Washington Foundation's Articles of Incorporation and Bylaws: Compliance with certain requirements for entity receiving assets of a charity	SR, p. 25-32.		
3.	Washington Foundation: No inurement to private persons: Compensation to Foundation directors	SR, pp. 25, 84; ES, p. 14.	P. 4.	
4.	Washington Foundation: Lobbying prohibition on the Foundation from lobbying against interests of health insurers	SR, pp. 25-28, 84; ES, pp. 11-12.		
5.	Washington Foundation: Prudent person rule	SR, pp. 28-30, 84; ES, p. 12.	P. 4.	
6.	Washington Foundation: Indemnification, conflict with bylaws and presumption of assent	SR, p. 30.		
7.	Washington Foundation: Amendment of Articles	SR, pp. 30-31, 84; ES, p. 14.		
8.	Washington Foundation Board of Directors' qualifications	SR, pp. 31, 85; ES, p. 14.	P. 4.	
9.	Washington Foundation: Timing of appointment of Third Board	SR, pp. 31-31, 85; ES, p. 14-15.		
10.	Washington Foundation: Investment Committee appointment and exercise of powers	SR, pp. 32, 85; ES, pp. 14-15.	P. 5.	P. 4.

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	ISSUE	C&B SOURCE REFLECTING ATTRIBUTION TO CHARITABLE TRUST AND/OR FAIR MARKET VALUE ASSUMPTIONS		
11.	Premera's Restated Articles of Incorporation: Objection to requirement that Foundation bear taxes associated with not receiving 501(c)(4) status	SR, pp. 33, 85.		Pp. 4-5.
12.	Transfer, Grant and Loan Agreement/Stock Restrictions Agreement objections	SR, pp. 33-35, 85-86; ES, p. 15.		P. 5.
13.	Objections to Premera's Articles of Dissolution and Plan of Distribution	SR, pp. 35-36, 86; ES, p. 13.		
14.	The transfer of fair market value	SR, p. 50; ES, p. 17.		
15.	Independence of the Washington Foundation	SR, pp. 60, 89; ES, p. 19.		
16.	The transfer of fair market value under the stock transfer documents	SR, pp. 60-62.		
17.	Stock governance agreements	SR, pp. 62-64		
18.	Role of the BCBSA	SR, pp. 64-66.		P. 5.
19.	Voting Trust and Divestiture Agreement ("VTDA")	SR, pp. 67-76, 89-90; ES, pp. 20-21.		P. 3.
20.	VTDA Divestiture Schedule	SR, pp. 67-72, 89-90; ES, pp. 20-21.		
21.	VTDA: Stock outside the voting trust	SR, p. 72.		
22.	VTDA: Voting of the shares by the trustee	SR, pp. 73-74.		
23.	VTDA: Nomination, election, and term of Board of Directors	SR, pp. 74-75, 90; ES, p. 21.		Pp. 2, 6.
24.	Termination of the VTDA upon termination of the BCBSA license agreement	SR, pp. 76, 90; ES, p. 21.		
25.	Unallocated Shares Escrow Agreement	SR, pp. 76-78, 90; ES, p. 23.		Pp. 7-8.
26	Failure to allocate shares between states	SR, p. 76.		

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	ISSUE	C&B SOURCE REFLECTING ATTRIBUTION TO CHARITABLE TRUST AND/OR FAIR MARKET VALUE ASSUMPTIONS		
27.	Registration Rights Agreement: Objections to New PREMERA's indemnification requirements	SR, pp. 78, 90; ES, p. 22.		
28.	Stockholder Protection Rights Agreement	SR, p. 79.		
29.	Excess Share Escrow Agent Agreement	SR, p. 79.		

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March 31, 2004

HAND-DELIVERED

Ms. Carol Sureau
Deputy Commissioner for Legal Affairs
Office of the Insurance Commissioner
State of Washington
5000 Capitol Boulevard
Tumwater, WA 98501

Re: *In re Premera,* OIC Docket No. G02-45
Pre-filed Direct Testimony of Premera's Witnesses

Dear Deputy Commissioner Sureau:

I am pleased to enclose the pre-filed direct testimony of Premera's fact and expert witnesses for the upcoming administrative hearing. Those witnesses are as follows:

1. **Sally Jewell, Chair of the Governance Committee, Premera Board of Directors** (and Chief Operating Officer of REI, Inc.): Ms. Jewell testifies about the extensive due diligence undertaken by the Premera Board before it decided unanimously to authorize management to seek regulatory approval for conversion. She explains the reasons for the Board's conclusion that Premera should increase its Risk Based Capital and that the best way to do so was to become a public company. As a public company, Premera will be able to raise capital without losing its independence, selling operating assets, or taking on unnecessary debt.

2. **Gubby Barlow, President and Chief Executive Officer of Premera**: Mr. Barlow describes Premera's business and the product and service improvements the company has been making to meet the needs of its customers. Mr. Barlow also testifies about the significant public benefits of conversion. He explains how conversion will help the company to remain a leader, grow its membership, and remain independent and Washington-based, while creating a health care foundation with hundreds of millions of dollars in assets to serve the unmet health care needs of Washington residents. Mr. Barlow also discusses the major changes that Premera has made in the Amended Form A to address issues raised by state consultants.

3. **Lew Reid, Former President and CEO, The California Endowment**: Mr. Reid testifies that the Premera conversion serves the public interest. Conversion will enable Premera, which is today fully taxed, to gain access to investment capital while creating two

health foundations that, on a *per capita* basis, are equal to or larger than the largest foundation ever created through the conversion of a BCBS entity. Mr. Reid describes in detail specific activities that other foundations have undertaken, and that the Washington foundation could undertake, to address unmet health care needs. Mr. Reid also testifies that the terms of the Amended Form A regarding the foundations' divestiture schedule and the relationship of New PREMERA to the foundations are fair and reasonable.

4. **Barbara J. Dingfield, The Giving Practice**: Ms. Dingfield, who provides consulting advice to philanthropic organizations, testifies about Premera's efforts to gather information from the health care community about Washington's unmet health care needs. She summarizes the feedback received through this process, including recommendations about the purposes that should be served by the Washington foundation.

5. **John Gollhofer, M.D., Chair of the Quality Committee, Premera Board of Directors**: Dr. Gollhofer, an obstetrician/gynecologist practicing in Spokane, testifies about the Board's and Premera's commitment to the health and satisfaction of Premera's members. He also testifies about Premera's relationships with contracting physicians and his belief that conversion will not have an adverse impact on physician reimbursement or rural healthcare.

6. **Thomas R. McCarthy, National Economic Research Associates, Inc.**: Dr. McCarthy testifies that, in his expert opinion, the Premera conversion will not lessen competition or tend to create a monopoly in the health coverage business in Washington. The conversion will not cause an increase in premiums, decrease provider reimbursement rates, or reduce consumer access to health insurance products or health care providers.

7. **Brian Ancell, Executive Vice President of Health Care Services and Strategic Development for Premera**: Mr. Ancell explains how broad and stable provider networks are important to Premera's success. He further testifies about Premera's provider reimbursement arrangements and levels of provider satisfaction.

8. **Roki Chauhan, M.D., Vice President of Medical Services and Medical Director for Quality at Premera**: Dr. Chauhan testifies about Premera's care facilitation programs. These programs emphasize preventive care, member education, and provider best practices. They enable Premera to facilitate patient access to better treatment, improve member health, and reduce medical costs. Additional funding will enable Premera to expand the scope and resulting benefits of such programs to policyholders.

9. **Heyward Donigan, Executive Vice President and Chief Marketing Officer for Premera**: Ms. Donigan testifies that the health insurance market in Washington is competitive. For-profit and not-for-profit companies currently serve the state. To the extent that such companies might not now compete with Premera in a particular product line or service area, they could easily do so. Entry by new competitors is also feasible. Competition drives pricing and

service in the state, and that will continue to be true whether or not Premera becomes a for-profit company.

10. **Jerry Lusk, Milliman USA**: Mr. Lusk testifies that, in his expert opinion, the conversion will have no material impact on Premera's premium rates. Mr. Lusk also finds that, because of market constraints, Premera cannot increase premium rates sufficiently to generate an adequate Risk Based Capital level. Mr Lusk testifies that it would not be practical or prudent to extend Premera's rate-related assurances for more than two years.

11. **Patrick M. Fahey, Chair of the Compensation Committee, Premera Board of Directors** (and Chairman of Regional Banking, Wells Fargo Bank): Mr. Fahey testifies that Premera's executive compensation and incentives are set by the Compensation Committee, which is composed entirely of independent board members. This committee obtains data and advice from independent consultants and establishes executive compensation consistent with industry best practices. Mr. Fahey also describes the development of Premera's stock plan, the Board's incorporation of state consultant suggestions into that program, and the compensation-related assurances in Premera's Amended Form A.

12. **Richard A. Furniss, Towers Perrin**: Mr. Furniss is a management consultant who specializes in executive compensation. He evaluates Premera's executive compensation programs and finds that Premera's current compensation levels are reasonable and appropriate. Premera has procedures and assurances in place to ensure that this will continue to be the case following conversion. Mr. Furniss further finds that Premera's proposed stock program is very conservative.

13. **Richard P. Fox, Chair of the Audit and Compliance Committee, Premera Board of Directors** (and Partner, RavenFire LLC). Mr. Fox testifies to the Board's strong commitment to Premera's financial and operational integrity. The procedures that have been put into place by the Audit and Compliance Committee ensure that the company operates in accordance with best practices. Mr. Fox also testifies that, following consideration of numerous alternatives, the Board concluded that conversion is the best way for the company to increase its Risk Based Capital.

14. **Kent Marquardt, Executive Vice President and Chief Financial Officer of Premera**: Mr. Marquardt testifies that the principal reason for undertaking this conversion is to provide levels of capital that can most effectively be obtained from the equity market, which will in turn enable Premera to enhance its operations, support membership growth, and provide excellent service. Mr. Marquardt also addresses issues raised by the state consultants concerning Premera's Amended Form A.

15. **Donna C. Novak, NovaRest, Inc.**: Ms. Novak is an actuary and consultant with both regulatory and NAIC experience. She testifies that Premera, its policyholders, and the

public will all be best served if Premera substantially increases its level of Risk Based Capital. She also testifies that raising equity is significantly better than other options available to Premera to increase its capital.

16. **Alan Smit, Senior Vice President and Chief Information Officer at Premera**: Mr. Smit testifies regarding the importance of sophisticated information technology to Premera's competitive position. He describes escalating demands to achieve integration and connectivity, to provide better customer service, and to meet regulatory changes. As a result of these demands, Premera's IT budget has increased substantially over the last four years. Mr Smit expects that Premera's budget for IT investments will continue to increase for the foreseeable future.

17. **Brian Kinkead, Banc of America Securities**: Mr. Kinkead testifies that, in his expert opinion, Premera's strategy to gain access to the public equity market is reasonable. He also testifies that the company will be an attractive investment and that the structure and terms of the proposed transaction will be acceptable to investors.

18. **Audrey Halvorson, Senior Vice President and Chief Actuary for Premera**: Ms. Halvorson describes how Premera develops premium rates in general and for its small group and individual customer segments in particular. She testifies that Premera cannot vary its premium rates for individual or small group products in different parts of the State in order to increase its operating margin in one region relative to its operating margins elsewhere.

19. **John M. Steel, Partner, Seattle office of Gray Cary Ware & Freidenrich, LLP**: Mr. Steel testifies that, in his expert opinion, Premera is a commercial enterprise, not a public benefit corporation, and its status as a not-for-profit corporation does not make it a charitable corporation. Premera's assets are not impressed with a charitable trust and, even if some were, the foundations that will be created as a result of the conversion will receive assets of far greater value than any allegedly charitable assets Premera may now hold. In addition, Mr. Steel testifies that the Premera Board fulfilled its fiduciary duties in investigating and assessing alternatives for capital formation via possible merger or combination. He also states that the arrangements between New PREMERA and the foundations are reasonable and customary.

I enclose a CD-ROM with electronic copies of the pre-filed direct testimony of Premera's witnesses, as described above, and four hard copy sets of the pre-filed testimony as well. By agreement among the parties, individual signature pages will be subsequently filed and served on counsel. Because the enclosed testimony has not been reviewed or redacted for proprietary information, it should not be posted on the OIC website until the redactions are complete. We expect to file and serve redacted versions of the enclosed testimony by the end of this week.

Please call me if you have any questions or concerns.

Very truly yours,

PRESTON GATES & ELLIS LLP

By Robert B. Mitchell
Robert B. Mitchell

RBM:lkc
Enclosures
cc: Lead Counsel of Record (w/encl.)
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